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Version: Version of Record

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<http://dx.doi.org/doi:10.21954/ou.ro.000100cb>

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The Development of the U.K. National Regime for Oil and Gas, 1934-1981

Submitted in (part) fulfillment of the
requirements for the award of the degree

of

Master of Philosophy (Government and Politics)

Open University

Date of Submission: September 1984
Date of Award: 3.1.85

September, 1984

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ABSTRACT

Development of the regime is related to the bargaining relationship between the British Government and the oil companies, tracing its influence (together with domestic and international considerations) on the decision making process which shaped the regime's character from 1934 onwards, and comparing British experience with a model of the Oil Company-Government relationship derived from Hossain.⁽¹⁾ Both onshore in 1934, and offshore in the middle Sixties, certainty of ownership and access to the resources for exploitation, is shown to have been a precondition for investment. This was resolved in 1934 by taking these resources into Crown ownership, and in the middle Sixties through the negotiation of an internationally agreed U.K. Sector of the North Sea. Negotiations for the establishment of that Sector are considered, explaining why a Regional regime was not adopted for the North Sea. The subsequent resolution of cross boundary unitization by Britain and Norway is also considered. In the 1964 offshore regime, company possession of scarce technology is demonstrated to have secured the industry generally favourable terms (the weakness of the Government being reinforced by the rapid development policy) yet the position of British Gas as monopsony purchaser, obtained gas at well below market prices. In 1973 the Public Accounts Committee criticised the regime in its application to the then recently discovered northern oilfields. The state of development of those oilfields, and changes in the international oil industry are shown to have made these criticisms premature in 1973, though by 1975 when regime changes did occur, both those conditions had considerably matured. The bipartisan approach to policy was breached in 1975 with the formation of B.N.O.C., after

Cont'd...

which the Hossain model is inappropriate, since policy progressively diverged on ideological lines, which will be demonstrated both through the subsequent history of the Corporation, and other regime changes introduced by the Conservatives after 1979. A final conclusion observes that the Hossain model may yet have some current relevance, as a consequence of the massive investments needed to extend U.K. self sufficiency up to the next Century.

- (1) Hossain, Kamal. Law and policy in petroleum development: changing relations between transnationals and governments.
London, Frances Pinter, 1979.

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Introduction The aim of this thesis is to show those factors, both domestic and international, which influenced the decision making process shaping the character of the U.K. National Regime for Oil and Gas from 1934 onwards. It will be demonstrated that amongst the most important of these factors was the bargaining relationship between the British Government and the oil companies.

The work of Keohane and Nye⁽¹⁾ provides a useful starting point for this task. Keohane and Nye established a framework for the analysis of World politics through a blending of elements from the "realist" and "global" interdependence positions. A set of distinct and complementary models were provided, so that alternative explanations were available for application in differing cases. Though the "realist" position (otherwise known as the "State centric" position) was appropriate for the treatment of some cases, Keohane and Nye developed a new explanation of interdependence, which they suggested was appropriate for the treatment of a large and increasing number of cases. They called their new explanation "complex interdependence". By contrast with the "realist" position, which stressed the prime importance of State power as expressed in economic and military terms, and the "global interdependence" position, which tended to the view that everything was dependent upon everything else, "complex interdependence" while taking account of both the domestic and international dimensions of an issue, stressed that the management of many international situations will frequently involve not only Governments, but also international organisations, multinational companies and other organisations.

It was in the context of "complex interdependence" that Keohane and Nye emphasised the importance of those sets of rules, laws and regulations, under

(ii)

which States are able to enjoy the benefits of international commerce, communications and investment, while at the same time appearing to maintain State power to the full within their territories. These arrangements constitute international (or regional) regimes, which may be established between States, or between States and other transnational actors. There are also national regimes which consist of those sets of rules, laws and regulations established by individual States with respect to issue areas within their own territories. In the shaping of such national regimes, States will often need to take account not only of domestic considerations, such as their relationships with organisations operating purely within their national territory, but also with wider and international considerations, such as their relations with other countries, and transnational actors such as multinational companies. Following the work of Keohane and Nye, there has been a steady growth of interest in transnationalism, particularly within the area of international business,⁽²⁾ together with a progressive integration of domestic and international concerns within vital issue areas.⁽³⁾

The purpose of regimes is managerial, and the management of the oil and gas resources of the North Sea has taken place under an international regime based on national sectors established by Treaty.⁽⁴⁾ Within these national sectors, North Sea States have developed national regimes to manage their oil and gas resources. Of these national regimes, that of the U.K. is unique, in that its origins can be traced back to 1934, when arrangements to manage onshore oil and gas operations were established through the Petroleum (Production) Act, 1934. Thus it affords, within the general context of regime management, an opportunity to study the particular relationship between the British Government and an important group of transnational

actors, the Multinational Oil Companies (MNOCs) over a period of nearly 50 years. This may be seen as a power relationship. Power is a concept which has always presented problems for the political scientist. The conventional definition of power, is the ability of an actor, at a cost acceptable to himself, to make another actor act in accordance with his wishes. Under "complex interdependence" the power resources available to the various actors, exist on multiple dimensions. The power resources available to a particular actor will not usually be congruent on all these dimensions. This situation creates the possibility for linkage between issues, and results in a power structure which is mediated through a bargaining process, so that outcomes on an issue will not always be those which seem likely at the outset of this process. Actors must employ their power resources in such a manner as to avoid undesirable or unacceptable consequences. For example, in the North Sea, the British Government enjoys the exclusive power to tax oil and gas operations within its own Sector, yet it cannot simply regard this source of revenue as a tap to be turned on whenever it requires additional income, but must take account of other considerations. Thus at the time of writing (early 1984), the tax regime has recently been modified to some degree in favour of oil companies operating in the North Sea, so as to encourage the exploration and investment needed to extend the use of our oil and gas resources into the next Century.

The development of the U.K. National Regime for Oil and Gas is to be studied from 1934 to 1981, though reference will be made to later events, where these throw light on the impact of earlier decisions. The end of 1981 has been chosen as a closing date for this study for the following reason. By the end of that year it was clear that the Conservative Government, not

withstanding earlier hesitations, was finally resolved to reduce the level of the State's involvement in the North Sea, through measures such as the partial privatisation of B.N.O.C.'s Upstream activities. The process of change initiated at that time, which has included a liberalisation of the tax regime in favour of the oil companies (1983), is still in train at the time of writing (e.g. the formation of Enterprise Oil), so that while changes within the British Sector of the North Sea and the international oil industry are clearly having an important impact on relations between the British Government and the oil companies, for the extent of that impact to be fully assessed, evaluation must wait till a later date. When that time comes, the most important of these recent developments will probably be seen to have been a sustained lower level of global energy demand and crude oil prices,⁽⁵⁾ together with a continuing diminution of the role of the Multinational Oil Companies (MNOCs) in the international oil industry. Such a situation, shaping the companies' perceptions both of their future profits and the economic viability of new projects, may well have been a significant factor in that modification of North Sea tax regime in a direction favourable to the companies, which was mentioned earlier.

As with any process of change,⁽⁶⁾ developments over so long a period as that between 1934 and 1981, necessarily involves a relationship between power and decision making. It will be shown that many of the constraints and opportunities in the decision making process, arose from the relative power of the oil companies and the U.K. Government in their bargaining relationship, together with the impact of the Government's other policy objectives, principally strategic in 1934, and largely economic from 1964 onwards.

The power of the oil companies was fundamentally weakened by the oil crisis of 1973 and the consequences of the Arab oil embargo, which brought about a major shift of wealth from the oil consuming to the oil producing countries. State power was everywhere increased within the oil industry, most notably within the oil producing countries, but as will be shown, to some degree within the oil consuming countries. As a consequence, National Oil Companies secured an increased share of the international oil business. As a response to this situation, the Western oil consuming countries, collaborated in the I.E.A. (International Energy Agency) of the O.E.C.D., on a number of measures, including the building of emergency stocks. The oil companies joined in this enterprise, since in the event of a future emergency, this would absolve them from some of the dangers inherent in sharing available supplies among their customers, which had presented such problems to them in 1973. These developments produced a particular difficulty for the U.K. which was both one of the Western oil consuming countries, but also an oil producer. This ambivalence was noted by Shackleton in 1977⁽⁷⁾ since when it has become more pronounced as Britain has moved towards, and then achieved, oil self sufficiency. A number of occasions will be identified when a degree of nationalism has played its part in determining the nature of British arrangements for the management of oil and gas resources. This suggests that the possibility of using those resources as a source of leverage in relationships with our European neighbours, may have been undervalued^(8,9).

Notwithstanding the watershed effect of the events of 1973, and the influence of other factors, it is intended to show that the major factor shaping the character of the U.K. National Regime for Oil and Gas, has been

the development of the relationship between the oil companies and the British Government. Hartshorn⁽¹⁰⁾ and Penrose⁽¹¹⁾ both made in depth general studies of the Oil Company Government relationship, prior to the events of 1973. More recently, Hossain⁽¹²⁾ has presented a very clear picture of how this relationship develops in a Third World context, based on his experience of Bangladesh. He seeks to identify the point at which power shifts from an oil company to a host Government. This occurs, he says, when adequate skills for ongoing management have been transferred to local personnel, and a significant deposit has been both located and developed. By then, the oil company has been trapped in an investment, from which it hopes to obtain a return, and from which it is both difficult and costly to withdraw. Much of this analysis is broadly applicable in a Western country, and it is hoped to show that this was substantially the case in the U.K. between 1934 and 1978.

The Hossain model certainly held good till around 1975, by which time some significant deposits of oil had been located in the northern North Sea, and their development was well advanced. At that point, the Labour Government were able to modify the terms of the Oil Company Government relationship by taking a more direct interest in North Sea oil and gas through the agency of a newly created National Oil Company, B.N.O.C. Till then, the nature of the regime had been predominantly constrained by the need to maintain the ongoing involvement of the oil companies. Thereafter, while this concern remained an important factor, that debate which can appear in a democratic society, both between and within Parties, on the best form of organisation for industry and the proper balance between the Private and Public Sectors in a mixed economy, was able to exert some influence on the shape of arrangements for the management of our oil and gas resources. From

1975 onwards, the Conservative and Labour Parties progressively diverged from the bipartisan approach to North Sea affairs which had existed prior to that date.

For these reasons, the Hossain model (which ignores ideological differences over economic management) is inappropriate for the consideration of events from 1979 onwards, when the Conservative Party took office with an ideology supportive of the virtues of free enterprise, and a complementary economic policy, which gave the control of inflation top priority, and thus achieved a sharp break with those principles under which successive Labour and Conservative Governments had managed the U.K. economy since 1945. In these circumstances, the new Government planned partially to privatise the Upstream (exploration and production) activities of B.N.O.C. The factors which at first restrained it from this policy, the conditions which brought about a reversion to the original intention, and the impact of these changes, cannot be explained by reference to the model derived from Hossain. Moreover, as will be shown below, the Hossain model suggests a permanent shift of power to the Government side in the Oil Company Government relationship once significant production has been achieved. However, in conditions of World depression, with a consequent depressed demand for crude oil, by late 1981 the U.K. Government was about to change the tax regime to favour the oil companies, in order to secure the really massive investment needed to extend the use of our oil resources into the next Century.

Notwithstanding these reservations, the model derived from Hossain remains a valuable tool for the analysis of the U.K. National Regime for Oil and Gas till the post 1975 period. The simple model derived from Hossain may

be set out in four stages as follows:

Stage 1 Encouraging Investment If it is to gain the interest of an oil company to investigate the existence of oil and gas resources, and if successful to carry forward a programme for their exploitation, then the State must first establish certainty of title to the subsoil and subseabed resources in its territory. This is a necessary condition for obtaining such investment, for without it ownership may subsequently be challenged. A Petroleum Law must be enacted which provides the prospective investor with a wide discretion on how he may run his business. The Government 'take' must be low, and generous provision made so that the company may offset its investment expenditure against tax. Such provision should not be worse than that of other countries competing for similar investment. A good return on capital invested must be allowed, having regard to the fact that most wells drilled may prove to be dry holes (i.e. without evidence of oil or gas), or not commercially viable. Lead times from the making of a significant find through its development to a fully producing field may be as long as 10 years. The State, in order to secure the necessary investment, may actually consult the companies with which it intends to enter into a relationship, in order to find out what conditions are needed to obtain their involvement. Thus the rules of the game may be formally decided by the State, but in practice, State power is highly permeable. The investment sought is one which consists not only of finance, but also of scarce technical skills.

- Stage 2 Decision to Invest The company investigates the country and the prospect through an economic, technical and political risk investigation or assessment. The likely existence of significant resources, and the possibility of their profitable development are both assessed. At this point, the decision to invest is taken. Power then rests very much with the investing company. It would still be able to terminate its investment, should either economic, technical or political conditions turn against it.
- Stage 3 Exploration and Development Exploration wells are drilled, and after a period of such activity, a significant, or commercial prospect is identified. The development phase now begins. By means of an extended process of development (which is highly costly) the prospect is now worked up to full production. The further the company becomes involved, and the more successful its efforts, then the greater becomes its investment, and the greater its need to protect that investment. It becomes progressively more costly to disinvest. During this stage, it remains the case that there is a considerable overlap of interests between the company and the Government. The company wishes to move ahead quickly to recoup its investment. The government has the same aim, in order to secure macro-economic benefits, speed technology transfer, train its nationals, and aid its balance of payments through import substitution. The company, for its part, uses locally recruited staff so as to reduce the costs of employing high cost expatriates.

(x)

Stage 4 Production With full production, all things being equal, power begins to shift to the government. At this point, State power becomes far less permeable. The government will now tend to change the rules of the game. They will be encouraged to increase their 'take', and to set up a National Oil Company, initially to participate in the Upstream (exploration and production) aspects of the business, and thereafter to move progressively into the Downstream phase of the business, consisting of refining, marketing, transportation and petrochemicals. With the initial intention of protecting its original investment, and latterly to secure its supply of crude oil, the company will go along with this process, and indeed participate in its implementation.

This sets the general context for the study. The following, are more specific details on how it will proceed.

PART 1 ESTABLISHING THE REGIME. This will consist of two chapters. It will be shown that decisions by which the U.K. Government took measures to establish the onshore regime in 1934, were made under the pressure of other priorities, primarily those relating to defence, but also requirements of economic recovery. Similarly, in 1964, the decisions which led to the creation of an offshore counterpart, were made under the impact of the need to provide a stimulus to the national economy. Downs has demonstrated⁽¹³⁾ how decisions made under the pressure of other priorities may influence decision making: options are reduced under the pressure of deadlines; important matters may be neglected; information used as a basis for decisions will be more limited; greater risks are taken.

Chapter 1, Creating the U.K. National Regime for Oil and Gas, 1934-1964, will first deal with the creation of the onshore regime in 1934. Reference will be made to earlier attempts to deal with the problem of establishing a framework for an oil and gas industry within the U.K., and these will be shown to have foundered through their failure to tackle the twin difficulties of settling the issue of who owned the U.K.'s oil and gas deposits, and the provision of access to those resources across private property. The early attempts to grasp these difficulties, were impractical, and it will be demonstrated that any practical measures to deal with them were not politically acceptable, because they would have infringed deeply held views on the absolute superiority of the free market economy, and the inalienability of private property rights. Such beliefs still predominated in the 1934 Parliament, but the danger of approaching war became an overriding consideration. Information from recently arrived German experts suggested that worthwhile resources might well exist, and that being the case, the Government judged that they had to be exploited. Indeed, in 1934, apart from a small section of the Conservative Party which opposed the necessary measures, the Government had general support from all Parties in the House for vesting the ownership of oil and gas in the Crown, and the provision of access to the drilling sites, subject to certain conditions.

Once these necessary conditions were achieved, the terms under which the companies would operate were exceedingly liberal (e.g. a very low royalty, and Mining (i.e. Production) Licences of 50 years duration). Evidence will be given to show that the Government probably received advice from within the oil industry on the terms and conditions set out in the relative Board of Trade Regulations. While the rules of the game were heavily weighted in

favour of the companies, an innovative licensing system, called the Administrative Allocation System (which was operated by Civil Servants on the basis of vaguely formulated criteria) enabled the Government to maintain a balance between British and Foreign capital. Thus while the rules of the game favoured the successful companies, the Government retained some power to determine who was actually to play the game. The successful applicants were happy enough, since they saved money which might otherwise have been spent on bidding for acreage. To indicate the virtues of the system in British circumstances, it will be compared with the U.S. system, and the Roumanian system as it operated in the prewar years. The view that this system was retained in 1964, because it brought benefits through bureaucratic satisfactions to the Civil Service, in line with the theory of Niskanen,⁽¹⁴⁾ is briefly discounted.

In 1964, the 1934 arrangements will be shown to have been substantially extended offshore, because (i) they were generally appropriate, and (ii) they were readily available. Whatever the views of the Parties on the ideal form of ownership for industry, and the balance between public and private ownership in a mixed economy, there was a bipartisan perception of the weakness of the economy, and a shared belief that rapid development would bring much needed macroeconomic benefits. At the outset, interest was centred on the southern North Sea, where significant gas resources were strongly believed to exist in strata extending from recent Dutch finds. Rapid development was therefore considered the best policy by both the Labour and Conservative Parties, with no significant body of dissent, and it will be demonstrated that this had an important impact on the character of the decisions taken. In order to encourage the oil companies to invest in the

British Sector in preference to other parts of the North Sea, British arrangements had to be in place before those of other States competing for the same resources of scarce capital and specialist technology. It will be shown that in the middle 1960's the general view of the activities of Multinationals held by most informed opinion in the U.K., was positive and uncritical. Given this attitude, which naturally extended to the Multinational Oil Companies (MNOCs), and the dominance of U.S. companies in the oil supplies business, from which those Multinationals obtained their specialist equipment, what followed was a serious failure of policy, namely the absence in the early years of any real and sustained effort to create a U.K. based offshore supplies industry. As the length of the development phase to bring the southern gasfields into production was relatively short, this reinforced the tendency of the oil companies to order equipment and specialised services through established sources of supply, with whom they had a satisfactory and ongoing relationship.

It will be made clear, that Norway waited till she could assess the conditions Britain had on offer to the oil industry, before formulating her own. She then made her own conditions broadly similar. However, since the nature of both her economy and her society favoured slow development, she made her acreage available at a slower rate than Great Britain. As a result, at the outset of her relationship with the oil companies, Norway had a somewhat stronger hand to play than that possessed by Great Britain. By contrast, Britain's policy of rapid development, which derived from the need to stimulate a quite different type of economy, necessarily weakened the British Government's hand at the outset of its relationship with the oil companies, at just that point when the Government hand in any Oil

Company-Government relationship is at its weakest. Noreng⁽¹⁵⁾ makes a valuable comparison of the relationships between the Norwegian and British Governments and the oil companies.

In Chapter 2, The North Sea Delimitation Treaties; the Cross Boundary Agreements, it is shown that the question of the ownership of Britain's North Sea 'territory' had to be settled (just like the ownership of the onshore deposits) as a necessary condition, before the companies could be expected to make the necessary investment. In settling the principal boundary in the North Sea, that between herself and Norway, Britain secured an early settlement on the basis of the Median Line Principle. No attempt was made to secure extra territory at Norway's expense by disputing her view that the Norwegian Trough was no more than an interruption in the Continental Shelf. In this, Britain combined good economic sense with fairness in her dealings with a valued friend and a N.A.T.O. ally. Had there been a disputed boundary, no capital would have been ventured in the disputed territory.

The reasons for settlement along National Sector lines are explained. Britain and Norway, with the lion's share of the North Sea between them were well satisfied, as were Denmark and the Netherlands, two small countries, who through the application of the Median Line principle, received substantial shares relative to their size and economic importance. However, this principle was applied in conjunction with the Principle of Adjacency, and the effect of this latter principle had an adverse effect on the West German share in view of her concave coastline. Though economically strong, West Germany was still politically weak, as a recently defeated country. When West Germany disputed the share she had received, the prior settlement of the

Britain-Norway boundary meant that when her Sector was renegotiated, this was not only done without reference to any recognised principle, but purely at the expense of Denmark and the Netherlands. France and Belgium had minute shares, though the French had some prospects on their large Atlantic coastline. Because Britain and Denmark were not members of the E.E.C. at the same time of the negotiations and Norway never did join, it will be shown that the opportunities for Community countries to apply leverage in favour of a Regional Regime were so restricted that such an outcome was never a serious prospect.

Since the exact location of the resources to be exploited was unknown, this helped to bring about an early settlement, as there were no disputes over the ownership of known deposits. However, it was known that the resources to be exploited were likely to be very large, and this, when combined with the previous factor, favoured a settlement along National Sector lines. Once a settlement along these lines had been achieved, it will be shown how this determined that any cross boundary arrangements would be according to an extension of the national principle, through complementary and mutually exclusive duties for States exploiting a common deposit. The settlement along National Sector lines could quite reasonably be viewed as being in accord with the "realist" or "State centric" view of world politics.

PART 2 DEVELOPMENT OF THE REGIME opens with Chapter 3, The Question of Regime Change: the U.K. National Regime for Oil and Gas, 1964-1975. This deals with a period when the formal aspects of the regime, such as its legal framework, remained unchanged, even though towards the end of the period, the power of the oil companies in their relationship with the U.K. Government was

significantly reduced. The basis of the gas regime will be explained, showing that while the cost plus pricing and the role of the nationalised gas industry as the sole or monopsony purchaser of North Sea gas was questioned both by the producing companies and in some academic quarters, on the grounds that it did not provide a price sufficient to stimulate the exploration needed to secure long term gas supplies, no such questions were asked either by or within the two main political parties. The claims of academic and company critics of the gas regime will be evaluated. While both Parties were satisfied with the existing situation where the companies were compensated for the low unit price they received for gas through a high rate of production, following from the rapid development of the southern gasfields, by the time of the 1970-1974 Heath Government, a more serious divergence was beginning to appear between the oil companies and the U.K. Government on the distribution of benefits between them, in connection with the exploitation of the newly discovered oil resources in the northern North Sea.

The evidence of this divergence will be shown by reference to the opinions expressed in the Public Accounts Committee, Session 1972-1973. The Committee took its evidence prior to the 1973 oil crisis. However, it will be demonstrated that the position of the Multinational Oil Companies (MNOCS) had already been substantially weakened internationally before that event. At the time when the Committee took its evidence, the considerable benefits obtained by other oil producing States, led to the view expressed in its Findings that Britain was relatively deprived by comparison. This deprivation was considered to follow from a failure by the British Government to adjust the rules of the game in its relationship with the oil companies, with sufficient speed to accord with this new reality. The events of the

1973 oil crisis certainly gave a fresh impetus to change, but it will be suggested that when changes in the U.K. National Regime for Oil and Gas were introduced in 1975, these changes owed more to the fact that by then the majority of the largest northern oilfields had been discovered, and their development phase was well in train. The changes made in 1975, will be briefly set out, and it will be shown that with one exception they were accepted on a bipartisan basis.

The one major change of 1975 which was not accepted on a bipartisan basis, was the creation of the British National Oil Corporation (B.N.O.C.). This will be covered in Chapter 4, State Participation: The Establishment and Subsequent Development of the British National Oil Corporation (B.N.O.C.), which covers the development of the Corporation up to and including the Thatcher Government's first and aborted attempt to modify the role of B.N.O.C. through a measure of privatisation, when first they took Office in May, 1979.

The differences between Multinational Oil Companies (MNOCs) and National Oil Companies (NOCs) are set out, and on the basis of the work of Leslie Grayson⁽¹⁶⁾ it will be explained why circumstances after the 1973 oil crisis led to a substantial growth in both the number and significance of National Oil Companies (NOCs), showing why this was so not only in the oil producing countries, but also in the oil consuming countries. The background to the establishment of B.N.O.C. is explained largely on the basis of the work of Krapels.⁽¹⁷⁾ The events of 1973 convinced the Heath Government that it lacked adequate information about the oil industry and sufficient control over North Sea oil operations. Both Shell and BP, with international

responsibilities for many customers, had refused to discriminate in favour of supplying the U.K. unless the British Government were prepared to issue them with a direct order, stating which of their other customers they were to discriminate against. BP was a company in which a controlling interest had been held by the U.K. Government since 1914, yet it had operated consistently under the convention that it was an entirely independent company, and thus it had become so. Labour experience of the attitude of the company during the Iranian crisis will be shown to have contributed to a particular distrust of BP on their part. Now that both the state of development of North Sea resources, and the fundamental changes taking place in the world oil industry, combined to make the time right for an increase of Government control over the North Sea, ideological differences between the two Parties on the proper means for organising industry asserted themselves, on the issue of how this was to be achieved. While the Conservatives favoured such an increase in control through a regulatory body such as the Alberta Oil and Gas Conservation Commission, Labour proposed to form a National Oil Company to secure this objective, and after they obtained power in 1974, such an organisation was created in 1975, in the shape of the British National Oil Corporation (B.N.O.C.).

The influence of Tom Balogh on the formulation of Labour's policy of setting up B.N.O.C. is outlined, and Labour's justification for setting up the Corporation is contrasted with the opposing arguments of the Conservatives. It will be shown that while power had shifted considerably to the Government side in the Oil Company-Government relationship, full nationalisation was not a serious possibility, and the proposed Conservative regulation seemed too weak. The manner in which B.N.O.C. "negotiated"

participation in existing leases through the threat of exclusion from future licensing rounds is described. The constitution of the B.N.O.C. Board will be explained, showing that it was formed free of company membership and influence, so that the company view was excluded from decisions, and a perfect control was maintained over information, obtained through the Corporation's membership of Operating Committees, even where it had no interest in the acreage. The manner in which the Department of Energy and the Corporation worked in close harmony, so that changes introduced to benefit the Corporation were held up till B.N.O.C. was ready to take advantage of them, with a consequent delay in work in the North Sea, is described.

To secure a measure of future independence the Corporation negotiated the Britoil Loan in the U.S. on the security of its participation crude, and then used the money obtained to pay off higher cost money borrowed from the National Oil Account. Thus it will be shown that when the Conservatives came to power, the loan still had a short period to run, so that fear of undermining the Corporation's crude oil base, leading to repayment, was a consideration in deterring the Government's first plan for partial privatisation. Of greater importance in this respect was the influence of Lord Kearton, who suggested that like successful private enterprise, a successful public enterprise needs a 'stream of profits' to secure its continuing success. In B.N.O.C.'s case, this 'stream of profits' would be impaired by selling off part of the Corporation's asset base, in the form of North Sea acreage.

Chapter 5, Conservative North Sea Policy, 1979-1981, and the Impact of Economic Policy, as demonstrated through Two Case Studies, the Gas Gathering Line Case Study, and the Clyde Field Development Delay Case Study, uses these Case Studies of two decisions, to highlight the significant factors which lay behind Conservative North Sea policy during a period when the policies of the two Parties had become most divergent. To identify the various factors involved, the decision of the Government to revert to its earlier policy of partial privatisation of B.N.O.C.'s Upstream (exploration and production) is considered. As a prelude to the whole, the assumptions behind Conservative economic policy are first set out. This policy diverged from those economic priorities which had been used by both Labour and Conservative Governments since 1945 as a basis for management of the U.K. economy, and adopted a strategy which made the control of inflation the principal policy objective in a policy which was closely complementary with the Party's free enterprise ideology, which favoured a reduction of the public enterprise role within the mixed economy. The timing of decisions was effected by the progressive eclipse of those elements within the Conservative Party which opposed the new approach. The need to maintain a high level of company commitment to the North Sea meant that by the end of 1981, in order to secure the high level of investment needed to extend the use of Britain's North Sea oil and gas into the next century, changes in the tax regime were in train designed to encourage the companies to that end.

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PART 1 ESTABLISHING THE REGIME

Chapter 1 Creating the U.K. National Regime for Oil and Gas, 1934-1964

1.1 The Onshore Regime, 1934 In retrospect, the importance of the onshore regime of 1934 does not lay in the modest production of oil and gas which resulted, but in the foundation it provided for the commercially very significant offshore regime of 1964, which will be considered in Para 1.2. The measures enacted in the Petroleum (Production) Act, 1934 and the Regulations (1935) under which Government licensees operated, arose directly from the bargaining relationship established at the time between the British Government and the oil companies. From 1934, up to the present, the various pressures and influences, domestic and international, operating on both the British Government and the oil companies, have been reflected in the decision making process which has shaped the U.K. National Regime for Oil and Gas. Thus it is necessary to establish, at the outset, those factors which exerted an influence on the decision of the National Government to create the conditions required to stimulate an oil search, and in so doing, to initiate a bargaining relationship between themselves and the oil industry. Setting up the onshore regime in 1934 involved the solution of two problems which had thus far inhibited any search for oil and gas within the U.K., on the part of any reputable oil company. Reasons will be advanced to show that in 1934, while strands of both economic and defence policy were involved in the decision to resolve these two problems, it was considerations of defence policy which predominated.

The nature of bargaining relationship established between the British Government and the oil companies in 1934 will be established, and in so doing

it will be shown that the first two Stages in the Model derived from Hossain were operative. The Administrative Allocation Licensing System, a novel system for the allocation of licenses will be shown to have brought benefits to both the oil companies and the British Government. These mutual benefits, and the appropriateness of the system to British conditions will be highlighted by its comparison with the U.S. method of auction or lease bidding, and the system of allocation as it developed in Roumania up to the mid 1930's. The reasons for the retention of the system in 1964 will be dealt with in Para 1.2, when considering the offshore regime developed at that time.

To assist these various objectives, the two problems inhibiting an oil search prior to 1934, the solutions adopted to these problems in that year, and the reasons why they were not solved earlier, will be set out in Para 1.11. This forms a basis for considering the decision which set up the onshore regime of 1934 in Para 1.12, and the resulting relationship between the British Government and the oil companies in Para 1.13. The Administrative Allocation Licensing System will then be treated in Para 1.14.

1.11 Two Problems Inhibiting an Oil Search The first of these problems resulted from the existence of oil and gas in fluid form in reservoirs, combined with the fact that in the U.K. there are thousands of landowners, the overwhelming majority of whom are small landowners. Thus to drill on most sites meant that any consequent production would draw oil and gas from beneath the land of surrounding landowners, and so infringe their rights. This could lead to legal disputes over the ownership of any such production. The second problem related to the fact that oil operations require the laying of access roads and pipelines, and negotiating access rights with possibly

many landowners, was a thoroughly daunting task. These difficulties, especially when combined with the fact that Britain was an unproved oil province, were sufficient to discourage investment by any reputable oil company in a search for oil and gas.

The problem of ownership was resolved in 1934, by vesting oil and gas rights in the Crown. The access problem was resolved, by granting all holders of either a Board of Trade Exploration Licence, or a Board of Trade Mining (i.e. Production) Licence, with guaranteed rights of access, subject to special controls for the protection of the environment, and to compensate landowners for loss and disturbance.

A plan to deal with the two problems inhibiting an oil search in Britain, while maintaining the rights of private property, had been proposed by the Duke of Northumberland, and considered when the Petroleum (Production) Bill was before Parliament in 1917. The extent of oil and gas reservoirs was to be determined by the Geological Survey, and a Fund to compensate landowners was to be set up on the basis of a production levy. U.S. experience had already shown that reservoir delineation required a drilling programme. If there was no oil and gas production, then the production levy would be inoperative, and there would be no Fund to compensate landowners for loss and disturbance. If there was a limited oil and gas production, the Fund would probably be insufficient to meet all the charges placed upon it. Both measures were rejected by Parliament due to their evident impracticality. Huxley ⁽¹⁾ describes how the provision for a production levy was removed from the Bill in August, 1917.

Despite the absence of legislation which would have encouraged the search for oil and gas in peacetime, the Lloyd George Coalition did carry out an efficient exploration programme in the U.K. during the 1st World War, using as their agents S. Pearson & Co. Ltd., an experienced oil company with important interests in the Mexican oil industry. This work was carried out under the extraordinary powers derived from the Defence of the Realm Act. As the conclusion of hostilities approached, the Government moved swiftly to underpin their exploration activities by normal legislative means, so that what remained of the Petroleum (Production) Bill became law as the Petroleum (Production) Act, 1918, in the same month as the Armistice. This measure was of interest, as it included a general licensing system run by the Ministry of Munitions. However, though adequate as a stopgap means to support the Government's exploration programme, it totally failed to address the twin problems of ownership and access, and so was completely ineffectual as a means of stimulating an oil search under normal conditions.

In 1921, the Lloyd George exploration programme was wound up, as part of a general retrenchment, and because it was difficult to justify such extraordinary Government activity in peacetime. (Footnote*).

In 1922, Bonar Law, Lloyd George's Conservative successor, while admitting that conditions were not right to stimulate an oil search in Great Britain, expressed the view that altering conditions in a favourable direction, was not the proper function of a British Government in normal times. Normalcy, in the sense that the term was used by politicians in the Twenties, meant in effect, peace abroad combined with an idealised view of pre-war business conditions.

Footnote* The preferential tax treatment of indigeneous oils introduced in 1918, was also ended in 1921, and not reintroduced till 1928. The measure was of particular value to the Scottish shale oil industry, which existed from 1873 to 1962. The shale oil industry treated very large quantities of shale in retorts to produce relatively small amounts of oil. The industry was rarely economic on its own account during the latter part of its existence. It existed with a declining workforce on the stimulus derived from the growth of the motor car and the intermittent provision of special tax support from the Government. When the Government's protective measures were finally ended in 1962, since they were judged incompatible with EFTA membership, BP's Scottish Oils Ltd., which ran the operation, ceased business, and the industry came to an end.

1.12 The Decision to set up the 1934 Onshore Regime The historian David Thomson (2) likened the National Government to a cautious firm of family solicitors, MacDonald, Baldwin & Co., presiding over the affairs of Great Britain Ltd., in very difficult times. Both men were conciliators, who had more in common with each other than they did with the more extreme members of their own Parties. Mowat (3) explains that the wartime pacifism of MacDonald had given a false view of his politics. He was anxious to make himself and the Labour Party acceptable to the Middle Classes, possibly as a response to his early experience of rejection. The few men he brought with him in 1931, when he broke with the Labour Party to form the National Government, held very orthodox economic views. Indeed, Snowden, as Marquand (4) relates, shortly proved this by resigning, together with the Samuelite Liberals, in opposition to the Protectionist measures entailed by the Ottawa Agreements (1931), and thus in this respect showed himself to be a

Gladstonian Liberal. Baldwin for his part, had the greatest difficulty in restraining Churchill from being excessively provocative during the General Strike of 1926. Mowat notes Stephen King Hall's observation, that despite their background, these two men brought in more Socialism than any previous British Government. By this, Stephen King Hall did not mean that they carried out the formal measures of the Labour Party's Programme, but that they involved the Government to a far greater extent than ever before, in the running of the economy.

The National Government were not Keynesians, but they were pragmatists. Faced with a serious economic crisis, which was the reason why it had been considered necessary to form an all Party Administration in 1931, they decided to deal with this crisis in the best way they knew how. That it, by a system of tax reliefs and subsidies to stimulate industry. The system they evolved was called 'managed capitalism' and under this system a whole series of 'new' industries, such as electrical engineering, publishing, rayon and vehicle manufacturing were developed. While the impact of this policy is a matter of some dispute, it is the view of certain economists that these 'new' industries made a substantial contribution to the economic recovery of Britain in the middle Thirties, (5,6) by means of which the National Government were seen to fulfil the 'doctor's' mandate of 1931.

If it is remembered that Nationalisation was not adopted as an industrial strategy in Britain till 1945, when the Labour Party came to power for the first time with an overall majority, then the measures introduced by the National Government to resolve the two problems which were inhibiting an oil search, will be seen to have been very radical indeed for the middle Thirties. These measures were justified on pragmatic grounds. The statement

by the Marquess of Londonderry to the House of Lords in 1934, in support of these measures is truly remarkable.

The Marquess reminded the House that he had always favoured the maintenance of private property. However, he had examined the measures proposed, and he had concluded they were essential to stimulate an oil search. No other measures would achieve this end, which were necessary both for economic reasons, and for reasons of national defence. The Crown already held a monopoly on gold, and received royalties on undersea coal. To extend the principle to petroleum seemed natural. This was a very effective statement, and doubly so since it was made by an Air Minister who was not only regarded as one of the least effective members of the Government, but whose background was that of a Conservative, an aristocrat, and perhaps most remarkably, a coalowner. It was the Coalowning Lobby which principally opposed the measures. Led by the Duke of Devonshire, they saw any support of oil and gas, and in particular those measures to stimulate the search for oil, as a threat to their own industry. At the same time they feared that once oil and gas resources had been taken into Crown ownership, this would provide a powerful precedent for the subsequent nationalisation of coal.

In November 1936, sometime after the Petroleum (Production) Act, 1934 was law, Winston Churchill in debate, described the years from 1931 to 1935, as the 'locust years' or years of wasted opportunities. These were the years when the fabric of international confidence was first shaken by the rise of Dictatorship, and the progress of aggression. Churchill charged that the Government had failed to rearm the nation and face this challenge. In answer, Stanley Baldwin made his often misunderstood 'appalling anxiety' speech.

Referring to the political reality of 1933/34, he argued that despite the Government's immense majority, the electorate would not have accepted a rearmament programme at that time. The situation to which Baldwin referred was as follows.

The Oxford Union Debate of 1933 had resolved 'that this House would not fight for King and Country' and in October of the same year a large Government majority was overturned at East Fulham, by a Labour Candidate of avowedly pacifist tendencies. The Peace Pledge Union was then exerting a powerful influence on public opinion, and the Labour Party was still led by the pacifist George Lansbury. To espouse formal rearmament at that time was not in Baldwin's view an acceptable political risk. Duff Cooper observed, (7) that even in 1935, he had to change a reference to Rearmament in the Army Estimates to Re-Equipment, so sensitive were his Cabinet colleagues on the issue.

The strategic importance of oil had already been well established before 1934. At the conclusion of the Great War, Lord Curzon had observed (8) that the Allies 'floated to victory on a wave of oil'. The importance of the various products which could be obtained from oil for the prosecution of a successful War effort, had also been demonstrated in that conflict. One of the essential requirements for shell production was toluene, a product of oil. While Britain was a major industrial nation, the 1st World War demonstrated at its outset many technological weaknesses, which lay behind the country's apparent naval and military strength. No adequate toluene plant existed in the U.K., and it will be recalled that the crisis over shell production was a major factor in bringing down the Asquith Government, and replacing him with a Coalition now led by Lloyd George. So worried had the

Dutch authorities become over the prospect of a British defeat, that on one occasion only they endangered their neutrality. One of the two toluene plants in the Netherlands, owned by the Royal Dutch Petroleum Co. (part of the Royal Dutch/Shell) was dismantled, and shipped across the North Sea, after feeding German Intelligence false information on the timing and route for the move. (9) Louis Turner relates (10) an occasion which underlines the importance of petrol in the War effort. On December 15th, 1917 Clemenceau appealed in these terms to President Wilson:

" the Allies must not let France lack the petrol which is as necessary as blood in the battles of tomorrow".

With a background of experience such as this, it is scarcely surprising that the British Government in the Middle Thirties, should seek to put its house in order with respect to fuel preparedness. Of course, in this connection it was hoped that the British Fleet would be able to control the seas across which crude oil was brought from abroad, but this did not mean that any measures could be neglected which might be taken within Britain. The Germans by contrast, would expect to suffer from a blockade, and might therefore be restricted to domestic sources, and such supplies as their armies could either seize or dominate within Europe.

From the British Government's standpoint, measures of economic and technical preparedness, which might coincidentally contribute to economic recovery, were less visible to the public than formal rearmament, and thus could prudently go ahead. That they did indeed go ahead will shortly be demonstrated, but a summary of European activities designed to secure fuel preparedness for war, laying particular emphasis on Germany, will be given

first, to underline why the British Government reacted as it did to prepare itself in like fashion.

During the early 1930's regular reports appeared in the Petroleum Times, such as that noted, (11) which indicated that France and Italy, were undertaking autarchic measures to extend the State interest in the oil industry, particularly in refining. In Italy, this involved an extension of the role of IRI (12) an organisation set up after the Risorgimento to stimulate the growth of industry in the then new but relatively underdeveloped country. At this time, there was no indication in the Italian case that such moves might in part be directed to preparing the country for aggressive action, such as that which took place against Abyssinia. The development of AGIP as a State oil company (1926), was seen more as an attempt to make Italy free from the influence of the Multinational Oil Companies (MNOCs), who controlled the major part of the international oil business. During 1933, regular Petroleum Times reports from Germany suggested little that was unusual. Indeed through most of that year, there was little evidence suggesting any activity comparable with that in France and Italy. Then at the end of the year, the evidence of the impact of the Nazi regime became clear, and the strident tone of official German Plans and claims communicated itself to the Petroleum Times reports. The lignite industry was reorganised, and then used as a basis for an extensive programme of coal hydrogenation to produce oil. The processes developed at that time, are even today the basis for those used at the South African Coal from Oil Plant at Sasolburgh, with the same objective of reducing that country's dependence on imported crude oil. Hydrogenation was not economic compared with products refined from crude oil. For the writers in the Petroleum Times, the implication of the German oil from coal programme was clear. They

concluded that the Germans were preparing for war. Other evidence tended to reinforce this judgement, as there was a considerable increase in the production of the Hanover oilfield, substantial increases in refinery capacity, and increased production of motor gasoline. The coming to power of the Nazis in Germany, however, led to a flow of emigres with technical know how to the U.K., and amongst these were some with oil industry experience, such as for example, the former head of the Prussian State Mines Department. Such people focussed attention on the prospects for developing domestic British oil production.

In a response to German measures, Britain responded as follows. In an attempt to improve performance, tetraethyllead was added to the R.A.F.'s aviation gasoline, and in order to meet its requirements for high grade aviation lubricating oil, the Duosol process was introduced into the U.K. (13, 14) Up to this time, the required products had surprisingly been imported from the U.S.S.R. A subsidy was introduced for oil produced from British coal. A plant was opened by I.C.I. at Billingham which produced benzol through hydrogenation, and continued to do so till 1946, when the Labour Government removed the subsidy at the conclusion of hostilities, and the plant was closed. Of course, in addition to the defence considerations, this subsidy also provided support for the depressed coal industry. Dr. Lander of the Fuel Research Station, developed a low temperature carbonisation process to produce oil from coal. This process was employed commercially and was known as the Cannock process. Those who favoured a still greater use of oil produced from coal, such as the coalowners, and Colonel F.A. Bristow, of Low Temperature Carbonisation Ltd., were dissatisfied. Britain after all had her Fleet to control the seas and

secure imports of crude oil. By 1934 however, it was stated in connection with the Air Estimates, that one Home Defence Squadron would fly on oil produced from British coal. In 1935, the Committee of Imperial Defence surveyed wartime fuel needs (15) and in the following year the Petroleum Press Service (16) reviewed these needs on the basis of the official work. Needs were assessed as threefold, consisting of (1) the needs of the U.K., civilian and military (2) the needs of the Dominions and Colonies, and (3) the need for dispersed stocks to be held worldwide, for the support of the Armed Forces overseas, particularly the Fleet. In this context, all the domestic measures described could only have a marginal impact. However, in the preparation for war, even such marginal measures acquire a significance beyond their ordinary economic importance. Such indeed was the case with the small production which might result from any British oilfields. Yet in the 15 years since the Petroleum (Production) Act, 1918, only 7 licences had been issued, and only 3 of these were still operative in 1933, one for the Duke of Devonshire's well at Hardstoft in Derbyshire, one for two wells which had been drilled at Three Bridges in Sussex, and another for drilling at Heathfield in the same County, in which case no drilling had taken place. (17)

The range of measures taken in connection with stimulating the economy, using the strategy of 'managed capitalism' fell far short (in terms of State intervention) of the form of public ownership adopted when the onshore regime for oil and gas was set up in 1934. It seems reasonable to assume from the evidence therefore, that if only economic policy considerations had been involved, the two problems inhibiting an oil search in Great Britain would have remained unresolved in 1934. Strategic concerns tipped the balance, so

that the prospect of conflict, and the need to be seen to respond to the German measures, provided a justification for radical action.

1.13 The Oil Company Government Relationship In bringing in the Petroleum (Production) Act, 1934, it can be shown that the National Government were positively seeking to create the conditions needed for the oil companies to engage in an oil search, and that moreover, a 'behind the scenes' bargaining process took place between those companies and the Government under which these conditions were established. This bargaining process established an ongoing Oil Company Government relationship in the U.K.

In April 1934, the Marquess of Londonderry followed up his initial statement to the House of Lords, mentioned in the previous paragraph, by proceeding to demonstrate that the oil companies would not invest in an oil search unless the Government's proposals went through. He quoted first from a letter received from a major oil company by the President of the Board of Trade (the Simonite Liberal W.G. Runciman):

"On several occasions during the past four years this company has been invited by various private interests to carry out exploratory work with a view to testing the oil bearing potentialities of certain localities in the U.K. While we are anxious to do all in our power to prove the existence of petroleum in commercial quantities in this country, we have hitherto not felt ourselves justified in acquiring surface and mineral rights from the numerous surface owners...."

The Marquess then quoted from the editorial in the Petroleum Times, dated 31/3/34 to indicate that no other qualified concern would undertake an oil search given the existing state of the law:

"the British Government has at last taken what appears to be the sensible step in cutting the Gordian knot which has deterred oil exploration in the past...ownership of oil will be vested in the Crown, and measures taken to remove the insuperable lease and royalty difficulties which have hampered oil search."

This statement clearly establishes that the British Government were seeking to establish the conditions necessary if the oil companies were to invest in an oil search. The next task is to demonstrate the behind the scenes bargaining process between the Government and the oil industry.

The Government received support from both the Labour Party and that part of the Liberal Party outside the Government, led by Sir Arthur Sinclair, in passing its proposals through Parliament. Opposition to the measures was limited to a small group of Conservative Peers and MPs led by the Duke of Devonshire, who owned the only producing well in Great Britain, that at Hardstoft in Derbyshire, which had been discovered by S. Pearson and Sons Ltd., in October 1919 (18) as part of the Lloyd George exploration programme. When the application of the Defence of the Realm Act lapsed, the Chatsworth Estates entered into legal action to prove the Duke's ownership of the production, and the matter was only resolved by an out of Court settlement. Lord Cowdray on behalf of S. Pearson & Sons Ltd., subsequently entered into tortuous and unsuccessful negotiations for further drilling rights from the Chatsworth Estates. Thus paradoxically, the experience of Lord Cowdray in trying to negotiate with the principal opponent of the new legislation tended to prove the need to resolve the problems of ownership and access which that legislation was designed to resolve. The Duke and his

supporters made much of the expertise which he supposedly derived from his ownership of the Hardstoft well. The Duke claimed that the 'waxy' quality of the crude produced at Hardstoft was due to bad handling of the well by S. Pearson and Co. Ltd., after its discovery. This claim was quite unjust. The well had only a very small production. The figures available are not too reliable. A figure of 30 tons a year was given in 1934, and Huxley quotes an admittedly unreliable figure of 218 tonnes for the year 1939, based on BP data.

The basis of the Duke of Devonshire's opposition to the measures lay in the fact that he was a coalowner, and thus opposed to any plans which were supportive of oil and gas, and detrimental to coal, since they assisted a competitive fuel. There was a fear that if one set of natural resources, oil and gas, were taken into Crown ownership, this would provide a precedent for the similar treatment of coal, through Nationalisation. It was claimed that the Government's proposals were Socialism, and thus unacceptable, yet at the same time the Group who surrounded the Duke of Devonshire were calling for further 'Socialist' measures, in the shape of more subsidies to encourage the production of oil from British coal. It was charged by the Duke's supporters that vested interests (presumably the oil companies) were behind the Government's proposals. The Marquess of Londonderry answered this charge by pointing out that in order for there to be a vested interest in natural resources, those natural resources had to be shown to exist. Since no such natural resources were so far known to exist, there could be no vested interest.

In the Commons, W.G. Runciman, President of the Board of Trade, defended

the Government's proposals. Lord Hartington pressed Runciman hard on the question of where the Government had obtained its advice in formulating the proposals. Walter Runciman answered this attack by specifically naming a whole series of technical societies, from which the Government had not received any advice. Significantly absent from the list of societies named by Runciman as not being the source from which it had obtained its advice, was the Institution of Petroleum Technologists (later the Institute of Petroleum), a centre of expertise funded by the oil industry, which might be expected to be friendly to the oil companies. Under further questioning Runciman was forced to deny that any advice had been obtained from this source. The Duke of Devonshire's supporters suggested that a return to the Duke of Northumberland's proposals of 1917 would suffice to stimulate an oil search, and in this they gained the support of the geologist E.H. Cunningham Craig (19) whose views however reveal his political opposition to any extension of the State's role in industry, rather than any grasp of the technological and legal realities to be faced in stimulating a search for oil in the middle Thirties. It remained as true at that time as it had in 1917, that in the last resort the presence of oil and gas could only be proved through drilling. The 1930's saw the growth of new geophysical methods which enabled a picture to be built up of the subsurface strata from surface observations. Yet these observations, while they might suggest that conditions were favourable for locating oil and gas, could not determine its presence with certainty. That had to be put to the final test of drilling. Thus the suggestion that the limits of reservoirs could be determined by the Geological Survey was as invalid in 1934 as it had been at the earlier date.

Evidence of a behind the scenes bargaining process between the oil

companies and the Government produced by the Duke of Devonshire and his supporters, has been shown above to have been little more than a strong suspicion. Moreover, given that this group had a special interest in discrediting the Government's proposals, their evidence must be suspect on this account. However, during 1935, evidence arose from a more reliable source, to suggest a behind the scenes bargaining relationship had been established between the oil companies and the Government. In mid year, the Petroleum Department of the Board of Trade issued the Regulations under which the Government's licencees were to operate, and the Petroleum Times (20, 21) observed that both the passing of the Petroleum (Production) Act, 1934 and the creation of the 1935 Regulations had been an exercise of considerable urgency. It noted that the expertise available at the Petroleum Department was limited. Given all these circumstances, the Petroleum Times considered a very good job had been made of designing the Regulations, and quoted the view expressed by Professor V.C. Illing of Imperial College, to the effect that the Regulations had been most skillfully prepared, in support of its own opinion. Professor Illing, as a young graduate, had been involved in establishing the Oil Technology Course at the Royal School of Mines in 1913, and both he and his academic colleagues were experts on oil technology and geology. They all had practical experience in overseas oil operations, to further which end Illing had set up the firm of V.C. Illing & Partners. Outside the oil companies, Illing and his colleagues were the obvious recognised source of expertise. It would have been quite reasonable for the Government to have approached these men for advice in formulating the 1935 Regulations, yet by implication (since Illing himself praised the manner in which the Regulations had been prepared), the Government did not avail themselves of this opportunity. This suggests that given the limited

expertise available to the Petroleum Department, the Government probably obtained assistance either directly from the oil companies or through the Institution of Petroleum Technologists. (Footnote*)

Footnote* A discussion with J.D. Hobson, a former pupil and colleague of V.C. Illing, and a present member of V.C. Illing & Partners tends to support this view. Hobson explained that he had known V.C. Illing for 40 years, from 1928 when he became one of his students, till his death in 1969. Hobson had been a colleague of Illing for some years at Imperial College, and a member of V.C. Illing & Partners from 1950. Firstly, he pointed out that Illing was an excellent businessman. Setting up V.C. Illing & Partners was a very shrewd business move, and Illing had done very well on the Stock Exchange, particularly he believed in rubber shares. Illing was a very able man outside his own specialities. When the Government had failed to ask his advice in 1934/35, this definitely rankled with Illing, and he tended to remember this on those occasions, when the Government had later to make use of his talents, as for example when he went to Washington on their behalf during the war. More particularly was this the case in the late 1940's when Illing acted as a negotiator on behalf of the Foreign Office, in the settlement of the Mexican Oil Dispute, which had resulted from the Mexican nationalisation of the oil companies' interests in 1938. Illing, who was never a company man, but had contacts in Mexico through his consultancy work, was well suited to this task.

However, while the Regulations were skillfully designed from the technical standpoint, the conditions under which the companies had to operate were hardly onerous. The Board of Trade which had the power to determine the level of royalty, or any other payment to be made, in 1935 fixed the royalty to be paid on crude oil at 4/- per ton, the royalty on gas at 2d per 1,000 cubic feet. The Regulations were designed to make sure that companies carried out operations according to sound oilfield practice. Applicants for a licence had to show that they possessed both technical competence and proper financial resources. Proper records of all operations had to be maintained, and kept available for regular monitoring by the authorities. Health safety and welfare provisions safeguarded the workers involved in operations. Attention had to be paid to the proper disposal of waste, and the safeguarding of the countryside. Safeguards were introduced into the Regulations to make sure that rights over any discoveries could not fall under foreign control. Most of these points involved safeguards that reputable oil companies would wish to maintain in their own interests.

Beyond the considerations mentioned above, the terms were generally designed to prove attractive to licensees, as can be shown with reference to the treatment of foreign capital, and the length of years, together with the extent of territory covered in the Exploration and Mining (i.e. Production) Licences.

Firstly, as regards the treatment of foreign capital, foreign based companies had to employ at least 50% British personnel, and one Director of their British subsidiary had to be British. Any well managed concern would be happy to meet these conditions in 1934, from a mixture of prudence and sound economic common sense. Employment of nationals of a host country,

wherever possible, was prudent as a safeguard against any nationalist backlash, and as a demonstration of a contribution to local employment prospects. It also made good sense for the company, as it was less costly to employ local personnel, compared with high cost expatriates. Viewed in these terms, the requirements for foreign based firms to employ British nationals, contained in the 1935 Regulations was not onerous, but it served the need of appearing to defend British interest against foreigners, in those rather more jingoistic times.

Secondly, considering the two varieties of Licence. The Exploration Licence was limited to 6 years duration, and covered some 200 square miles. This was designed to stimulate rapid exploration. On conversion to a Mining (i.e. Production) Licence, the Licence was restricted to half the original area, though as Noreng ⁽²²⁾ explains with reference to the use of this provision at a later provision, the company was usually able to negotiate retention of the most favourable part of the territory covered in the original Exploration Licence. Of particular importance in the context of the Oil Company-Government relationship, was the duration of the Mining Licence. This lasted for 50 years with an option available to the Licensee company, to extend this period for a further 25 years. Thus, having taken subsoil rights into State ownership, in order to solve the problems of access and ownership, quite remarkably these rights were disposed of on exceedingly generous terms to the oil companies. While the duration of a Mining (i.e. Production) Licence encouraged the oil companies to engage in the search for oil and gas, indicating that Stage 2 of the model derived from Hossain was in operation, in later years, critics were to point to this provision as a serious weakness in the regime, especially as no arrangements were included in the Regulations

for any renegotiation of terms before the expiry of the lease.

The results of the Petroleum (Production) Act, 1934 and the 1935 Regulations in terms of oil and gas production were very modest, as shown by a survey published by the Institute of Petroleum in 1965 ⁽²³⁾ of the years 1934-1965, which identifies two peaks in oil production, one in wartime in 1942 (in excess of 100,000 tons of crude oil) and a second in 1964 (in excess of 130,000 tons of crude oil). A more detailed analysis of the period of 1939-1981 by Huxley confirms the picture presented by the Institute of Petroleum, and highlights how the level of onshore effort fluctuated relative to two factors. The first of these factors was the steady advance in exploration techniques and drilling technology, which provided an ongoing stimulus for fresh effort, and the second factor was the price of crude oil imports relative to the cost of British production. Huxley also gives figures for natural gas production. ⁽²⁴⁾ (Footnote*).

In 1934, a further incentive to onshore oil exploration was provided by the tax relief on motor fuels produced from indigeneous oils. It was hoped this tax relief would offset the drilling and capital costs associated with the search for oil, and at the same time make British produced oil competitive with foreign imports. Certainly, this support sustained onshore exploration effort in the earlier years.

Footnote* The first success of the onshore regime was the discovery of the small Midlothian Field by the Anglo American Oil Co. Ltd., (an Esso subsidiary) while some months later BP discovered gas at Cousland. Thereafter, the following oil and gas acumulations were discovered in mainland Great Britain up to 1964: 1939 (Eakring; Eskdale, Formby); 1941

(Dukes Wood, Kelham Hills);; 1943 (Kelham, Nocton); 1953 (Plunger); 1955 (Egmanton); 1956 (Ironville); 1957 (Calow, Trumfleet); 1958 (Bothamshall, Corrinham); 1959 (Gainsborough, Kimmeridge); 1960 (Apleyhead, South Leverton); 1961 (Glentworth); 1962 Torbsey); 1963 (Beckingham, Wareham).

1.14 The Administrative Allocation Licensing System This system, which was introduced in 1934 and retained in 1964. The reasons for its retention at that time will be explained in Para 1.2. The system involves Licensing Rounds, in which the Government announce the territory which is to be allocated, and invite applications from prospective licensees. In each Licensing round, the normal approach has been to state vaguely worded criteria, against which the Civil Service must judge the appropriateness of applications, and allocate territory accordingly. The best way to appreciate the benefits accruing to both the oil companies and the Government from this arrangement, is to contrast the consequences of this system of allocation with the methods of licence allocation used elsewhere in 1934, in Roumania and the U.S.A.

In the United States, the system known as auction bidding, or lease bidding operated. (25) In that country, subsoil rights in oil and gas were privately owned, and were disposed of through an auction, so that the highest bid secured the lease. It has been explained by Odell (in the context of the post 1964 offshore experience) (26) that this system could have secured the British Government a high income. In the British context, controls on the manner of exploiting a lease might still have been imposed on the successful bidder. In the U.S.A. there were of course large unproven areas, but it was also the country in 1934 with the most highly developed oil industry. By

contrast, in Britain at the same time there was no significant exploration and production activity, and the British Government's aim was to stimulate an oil search and not to secure revenue. If a private owner of subsoil rights in the U.S.A., leased his land for the purposes of oil and gas exploration, he had no other objective than to make money. Administrative Allocation was designed to suit the oil companies, and to encourage them to apply or what was after all unproven territory. The companies argued that the money saved through their not having to bid for territory in Britain was then available to help them cover their exploration costs.

The system used in Roumania, regime described in great detail by Maurice Pearton (27) offers another model which demonstrates the appropriateness of the Administrative Allocation Licencing System to British conditions in 1934. The country had an underdeveloped economy and was heavily dependent for its prosperity on its grain and oil exports. Since its establishment in the 19th Century, and more so since the formation of Greater Rumania in 1918, it was reliant for its survival on the maintenance of good financial and diplomatic relations with other European States. Yet the autarchic principles of the German economist Friederich List, and the slogan 'Roumania for the Roumanians', dominated the management of oil resources, with consequences which conflicted with the achievement of these financial and economic objectives. Up till the 1930's both the Government and the Bureaucracy in Roumania were dominated by the National Liberal Party which operated on these autarchic principles, and even though the dynastic problems between the wars destroyed the Party's dominance, commitment to the autarchic approach to economic management was retained.

Under the Roumanian system of licence allocation, which derived from

this approach to economic management, territory was first allocated for licensing according to whether it was oil bearing or largely unproven. Then it was distributed amongst four categories: (1) State reserve (2) areas allocated only to Roumanian companies (3) areas allocated to companies already in business in the Roumanian oil industry, and (4) new foreign capital. This is a highly simplified version of a complex system, the aim of which was to nationalise the oil industry. It should be explained that the Roumanian use of the word nationalise meant to place the industry progressively in Roumanian hands, so as to provide jobs for the Roumanian technical elite. It was not the same as Nationalisation in the British sense. Not only was Roumania's system highly complex, it was also highly discriminatory. Roumania could employ this method only as long as she had oil which other countries wanted. During times of depression, when demand for oil fell off, Roumania suffered economically due to the offense this system gave to those countries and financial interests whose goodwill she needed as a guarantee of her very existence. Britain, in 1934, with no oil and gas, could never operate such a system.

The Administrative Allocation System, as operated in 1934 (i.e. with all major interests receiving a fair share of the allocation), was a highly flexible system, in so far as the principles of allocation were loosely drawn, and the possibility of discrimination always remained in Government hands should circumstances change. At a later stage it will be shown how this capability for discrimination was used in 1964, in order to maintain a fair balance between British and foreign capital in the North Sea, while later still it will be shown, how from 1975 onwards, Labour used such

discrimination as a lever by excluding or threatening to exclude from a fresh Licencing Round, those companies which refused to negotiate a State interest in existing Licences. Yet in 1934, as also in 1964, the overlap of interests between the oil companies and the British Government was so great, that the system as operated proved mutually beneficial.

1.2 The Offshore Regime, 1964 In August 1959, a Shell/Esso team located a large natural gas reservoir at Slochteren in the Groningen Province of the Netherlands. The Slochteren Field was connected with geological formations stretching right across the North Sea. As a result of the Slochteren discovery, widespread investigations began to estimate the North Sea's oil and gas potential. A belief was soon manifest that a major oil and gas province might lay beneath the North Sea, and in particular, that substantial quantities of gas might be available in the more accessible, shallower and less inclement waters of the southern North Sea, even though it was accepted that to attempt the recovery of this gas would mean operating at the frontiers of offshore technology. Investigations culminated in 1963 in a magnetometer survey of the North Sea, stretching from Aberdeen to the Southern tip of Norway, and then south to the Straits of Dover. (28) This survey was sponsored by the 10 largest European oil companies.

All this activity created pressure on the interested European Governments, to solve two questions, which were parallel with the two problems which the British Government had faced alone when establishing the onshore regime in 1934. Firstly, it was necessary to establish who owned the oil and gas which might lay beneath the North Sea. This question is reserved for Chapter 2 which covers the setting up of an international regime for the

North Sea, based upon a system of national sectors. The second question related to the issue of what were to be the conditions under which those national sectors, once delineated, were to be exploited. The approach of the British Government to this second question was determined (as was their negotiation of sector delimitation) by the bipartisan rapid development policy supported by both the Labour and Conservative policy. It will be shown how this rapid development policy came to be viewed as essential by both Parties. The factors involved in deciding an appropriate development policy for the U.K., will be highlighted by showing how the entirely opposite conditions of Norway's economy and society, caused the Government of that country to opt for a policy of slow development, based on the assumption that the oil would increase in value if left in the ground. Then it will be demonstrated how Britain's rapid development policy shaped the Oil Company Government relationship, and much of the character of the 1964 offshore regime. The reasoning behind the rapid development decision will be covered in Para. 1.21., and then contrasted with the Norwegian approach in Para 1.22, thus providing a basis for considering the shape of the 1964 offshore regime in Para 1.23.

1.21 The Rapid Development Policy Decision In the early 1960's the growth rate of the U.K. economy was slower when compared with that of our European neighbours. In 1960, U.K. per capita income ranked second only to that of Luxembourg, comparing the U.K. with the original six members of the E.E.C. By 1976, the process of relative decline had so advanced that we then ranked 7th in the Nine. By 1964, it was already clear that much of Britain's economy consisted of declining industries, and though technical change was often feasible within these declining industries, much of the embodied

technical change proved ineffectual due to restrictive practices and Trade Union insistence on the overmanning of machines. Newer industries, such as the Upstream (exploration and production) side of the oil industry, were viewed as less likely to be encumbered with a legacy of restrictive practices. In the previous year (1963), the MacMillan Government had been rebuffed by De Gaulle in their attempt to take Britain into the E.E.C. The hoped for benefits of E.E.C. entry which would give a stimulus to the U.K. economy were not dissimilar from those benefits which it was hoped would derive from the development of an offshore oil and gas industry. It was believed that rapid development offshore would stimulate technical change, create employment opportunities, and provide the basis of a new British oil technology industry founded on traditional engineering skills. New opportunities would be provided for the shipbuilding industry. These changes would have a multiplier effect, which would spread benefits into the wider economy, and thus have a positive influence on our growth rate.

The mid 1960's in particular were characterised by alternating period of 'stop' and 'go'. Periods of 'go' involved an overheating of the economy, and resulted in what by later standards would be regarded as a modest increase in inflation, but which for the time seemed exceptional. Available resources within the domestic economy became largely employed. Raw materials imports to make good this deficiency then created pressure on the balance of payments. In order to contain the resulting drain on the balance of payments, a period of 'stop' was imposed by the Government, involving some form of wage control. The balance of payments problems interacted upon exchange rates, then fixed according to the Bretton Woods System, and

defended by Government action. A formal devaluation, as Harold Wilson learnt, was often the occasion for speculators to gain at the expense of the economy, while for its part under the threat of leaks, authority had to persist with denials of any intention to devalue right up to the event itself. A very important component in the balance of payments was the cost of imported oil.

The costs to the balance of payments associated with imported crude oil was the result of changes in the U.K. fuel economy since 1945. At the end of the War, our fuel economy was still substantially based upon British produced coal. A steady increase in coal production took place throughout the post war period till 1955.⁽²⁹⁾ However, as the demand for fuel increased, crude oil, which was cheap, environmentally acceptable and readily transportable, began to take an increasing share of the U.K.'s energy requirements. The temporary interruption of oil supplies brought about by the Suez Crisis (1956), caused little more than a pause in the changeover from coal to oil. Little consideration was given to the question of security of supplies in the middle Fifties, notwithstanding the admittedly interested warnings of E.F. Schumacher and Lord Robens, on behalf of the Coal Board. In the U.K., the power of the Unions restricted the rate of contraction of the coal industry, so that by 1964 solid fuel production still stood at the relatively high level of 198 million tonnes of coal equivalent. However, by the early Sixties, the relief which might accrue to the balance of payments from an indigenous source of oil and gas, provided a reinforcement to the macroeconomic arguments in favour of a rapid development policy.

While these two economic reasons provided the principal cause for the adoption of a bipartisan rapid development policy, two other considerations

helped to shape the decision of the U.K. Government. Security of supply, was one of these two considerations, and was judged to be of far lower importance than the economic considerations already mentioned. Treverton (30) has explained that there was still a very low appreciation of the importance of the security of supply issue amongst the Western Nations in the mid 1960's. The second of these two other considerations was the need to defend the position of Shell and BP, a part British and wholly British Multinational respectively (31) against any claims for a greater level of participation in their domestic oil industries made by oil producing States, in particular those in the Middle East. A U.K. regime in the North Sea could not establish any precedent for an extension of the involvement of these States in the oil industry within their own borders. In practice, the first serious challenge to the position of the Multinational Oil Companies (MNOCs) in the Middle East, occurred in 1967. Fadil Al-Chalabi (32) describes how in that year, Libya took advantage of the fact that some 20 companies were engaged in operations within her territory, some totally dependent on Libyan output, so as to confront them in detail. A 30¢ U.S. price increase was obtained, together with an improved tax yield, and most important, the acceptance of the principle of annual price increases. These now seemingly modest changes brought about a chain of modifications in the conditions under which Western oil companies were to operate in the Middle East, which were ratified in the Tehran Agreement (1971) and a series of associated sub regional agreements. This resulted in a 15% increase in the 'take' of the Host Governments, and considerably undermined the position of the companies in the Middle East, somewhat before the events of the 1973 oil crisis. Thus the two considerations given the least weight in opting for a rapid development

policy for the North Sea and formulating an appropriate regime to manage the task, were to acquire added significance shortly after 1964. The difficulties arising from a decline in the power of the Multinational Oil Companies (MNOCs) in the producing countries were foreseen at that time, but the time scale was wrong, and both the companies, and U.K. Government believed that these difficulties lay some 10 years in the future, rather than just ahead of them. In 1964, it seemed important to bring about gas production as rapidly as possible, and in this context the need to maximise Government income was viewed as less important.

1.22 The Norwegian Approach To highlight the reasons for those characteristics of the U.K. regime to be considered in Para 1.23, it is useful to contrast the political and economic objectives of the U.K. Government with those of their Norwegian counterpart. Norway opted for a policy of slow development, or 'leaving the oil in the ground' as a result of her quite different needs. The differences between the two countries which resulted to their differing approaches to the development of oil and gas are as follows:

Norway

A very large land area, with a very small population, and a homogeneous society.

An economy based on three related industries: agriculture, fishing and shipbuilding.

Great Britain

A smaller land area, with a large population and class divisions in society.

A diverse economy and a fully developed industrial society, suffering from the problems of declining traditional industries,

Cont/...

Norway

Adequate supplies of clean indigeneous fuel: hydroelectricity. This industry run by the State company Norske Hydro. No coal industry.

No balance of payments problem associated with a heavy dependence on imported crude oil.

Social Democratic Governments back to the 1st World War. Established tradition of State intervention in industry.

Strong but democratically based nationalist tradition intent on defending national interests. Based upon long experience of foreign domination, firstly under Denmark, and then under Sweden till 1905.

No security of supply problem

Great Britain

and difficulties in achieving structural change

Energy economy undergoing change, with a rundown of the coal industry in favour of environmentally acceptable liquid fuel.

Balance of payments problems aggravated by the costs of crude oil imports.

First majority Labour Government took Office in 1945.

An equally democratic society, but with no experience of foreign domination, and a strong need to secure the investment of foreign capital.

Security of supply problem, but danger still not fully perceived.

Norway

No Norwegian based oil multi-nationals

Energy consumption of 20 million tons of coal equivalent per annum.

Great Britain

Shell (British and Dutch) and BP (British).

Energy consumption of 300 million tons of coal equivalent per annum.

With a far lower energy requirement, which was already largely covered by her environmentally acceptable hydroelectricity, and with none of the problems associated with the need to changeover her energy economy from coal to oil, Norway had no overriding need to employ substantially larger amounts of oil and gas domestically. While her balance of payments position would be improved by exports of oil and gas, she had no great need for this oil and gas as a means of substituting an indigeneous energy source for the cost of crude oil imports. Neither had she any serious security of supply problem. There was no need to stimulate the development of new industries particularly for the purpose of overcoming difficulties associated with structural change. Moreover, as the small Norwegian labour force was already fully employed, over rapid development would have effect of bidding up wages and inducing inflation, while draining labour away from the traditional industries such as fishing and agriculture. Indeed, rapid development might bring with it the dangers of pollution which could damage the fishing industry. For these reasons, the development of the new oil and gas industry was firmly controlled within the framework of Norway's regional policy.

A Petroleum Committee, appointed by the Minister of Trade and Industry, reported that the formal terms offered by Norway to the oil industry, had to be at least as good as those offered by Great Britain, otherwise investment

would be driven into the U.K. Sector. However, it was decided to offer less acreage at less frequent intervals than Great Britain. Thus the Norwegian 1st Round (1965) covered a smaller area than the British 1st Round (1964), and it was 1969, before the Norwegians embarked on their second Round of Licencing. In their respective 1st Rounds, the Norwegians offered 78 blocks and the British 340 blocks, and a British block was roughly twice the size of its Norwegian counterpart.

The Norwegian policy of slow development was based on a very shrewd financial assessment. The Norwegians correctly judged that the price of crude oil would increase so quickly that the benefit derived from leaving their oil in the ground would exceed the profit to be obtained from investing the proceeds of its sale at current prices into their economy. The Norwegians considered that slower development would lessen the extent of their dependence upon the oil companies. Though the degree of their dependence on the oil companies was indeed lessened, it remained considerable for reasons shown in Para 1.23, which sets out the factors which shaped the 1964 U.K. offshore regime.

1.23 The Shape of the 1964 Offshore Regime In the early 1960's, marine petroleum engineering was still a fairly rare expertise. (34) During the late 1940's and the 1950's the technology had been developed for shallow depths only in the Persian Gulf and the Gulf of Mexico. The expertise, insofar as it was available, was principally in the hands of the seven Major Oil Companies (known as the Majors), and the large American independent oil companies (known as the Independents from the fact that they were independent of the Majors.) Thus from the standpoint of European States wishing to

develop the resources of their North Sea Sectors, a significant part of the available technology was in foreign (principally U.S.) hands. There was no alternative source from which the relevant technology could be obtained, neither could the necessary skills be developed locally in the short or medium term. Even those companies which held the virtual monopoly on the available technology had great difficulty in obtaining and retaining good managers and petroleum engineers for offshore work. Only limited expertise of this type was available to host Governments wishing to supervise the work of the companies. Thus while slow development reduced dependence upon the oil companies, and a more rapid development increased that dependence as in the U.K., in neither Britain or Norway was there any early prospect of nullifying that dependency. Such was the background against which the U.K.'s 1964 offshore regime was established.

Given the desire to encourage both massive financial investment and the employment of scarce technology and personnel in the U.K. Sector of the North Sea rather than elsewhere, British conditions had to meet two criteria. Firstly, British terms had to be on offer before those of other competing States. Secondly, those terms had to be more attractive to the oil companies, than the terms likely to on offer from elsewhere. Such an approach, might have disadvantages for Britain, and the nature of these disadvantages will be explained in Chapter 3, which deals with the development of the regime in the years up 1975, when the then Labour Government introduced fundamental changes in the arrangements, principally effecting the development of the oil resources of the northern part of the British Sector of the North Sea. At this point, the broad dimensions of the

U.K.'s 1964 offshore regime will be covered, leaving more detailed consideration for treatment in Chapter 3.

Dealing first with the legal dimensions of the regime. Partly from the urgent need to have British arrangements in place before those of other European States competing for investment in their North Sea Sectors, and also because the models available in the legislation of the 1930's were well suited to the purposes of the middle 1960's, given the general weakness of the British Government in the Oil Company Government relationship, the Continental Shelf Act, 1964 and the Petroleum Production (Continental Shelf and Territorial Sea) Regulations, followed fairly closely the spirit, style and content of their middle 1930's onshore counterparts, except of course that they contained certain features reflecting their application offshore, such as clauses in respect of navigation. The fees from licencees, and the royalty payable- 12½% on the wellhead value of petroleum- remained modest. The length of a Mining Licence was reduced from 50 and 40 years, but the length of this licence to exploit State property still remained exceedingly generous to the licensee. Very significantly though, since in 1964 interest was centred on the gas potential of the southern North Sea, the Nationalised gas industry was made the only permitted purchaser of any gas produced by the companies. The Administrative Allocation Licensing System was retained from 1934, not because of any vested interest in its retention by the Civil Servants who were to determine the allocation of the licences, but because it could be used to ensure that a fair proportion of the work involved could be allocated to British, or part British interests, principally BP and Shell. Even though 62.5% of the territory allocated in the first 4 Licensing Rounds went to foreign (largely U.S.) concerns, which was an inevitable outcome of

the distribution of the available expertise, British companies obtained a good share of territory.

Turning now to the financial aspects of the exercise. With massive amounts of money involved, the Majors, till then traditionally self financing, were forced to move into external financing. The risks to be taken through the operation of untried technology at greater depth than formerly in more inclement conditions, meant that the rate of return on capital invested, had to be well in excess of the average rate of return on capital investment of 15% which then applied in the U.K. economy⁽³⁵⁾. Slochteren, a simple enterprise by comparison, had achieved a rate of return on capital invested of 25%. One of the means employed to secure for the oil companies and the other financial institutions involved a favourable outcome in respect of the rate of return on capital invested, consisted of an offshore tax regime limited to a modest royalty, applied in the context of the normal application of U.K. Corporation Tax. This was a system described by MacKay and MacKay as being 'porous as a sieve'. Companies were able to set off quite extraneous expenditure (e.g. a tanker for use outside the North Sea) against their North Sea costs. They could further extinguish their U.K. tax liability through setting against it overseas losses and tax payments, through the operation respectively of transfer pricing and double taxation relief. The manner in which this was done will be covered in some detail in Chapter 3, as will the consequences for the U.K. Exchequer, but it is well to recall that in 1964 the achievement of revenue was by no means an important Government objective.

Whereas the bargaining relationship between the oil companies and the

Government had been covert in 1934, since the government wished to avoid the charge that it was selling out to 'vested interests', in 1964 and thereafter, both sides took up public positions, for example on the price to be paid to the companies for gas by the Nationalised Gas industry. The Government wished to demonstrate that they were not paying too high a price for the gas, while the companies sought to show that they were being underpaid.⁽³⁵⁾ In the event, the bargain finally struck consisted of a relatively low unit price, combined with a somewhat higher rate of extraction than the gas industry actually required. Thus the total cash flow of the companies was increased by producing at higher volumes. The longer term consequences of this approach will be considered in Chapter 3. The argument between the two sides was concerned with the question of an appropriate division of economic rent, while the companies claimed that the low unit price paid them for gas was insufficient to justify the exploration needed to secure longer term supplies, through the discovery and exploitation of smaller deposits. Economic rent is defined by MacKay and MacKay ⁽³⁷⁾ as the difference between the full market price of a product, and that price which is just sufficient to keep an operator in business.

Given the desire to secure macroeconomic benefits through rapid development, the Ministry of Power became involved in arranging some contracts for the U.K. engineering industry to supply the special requirements of the new offshore industry. Jenkin ⁽³⁸⁾ relates that the outcome of this effort was not a success. The British engineering industry performed poorly in terms of technical quality and delivery, since there had been no special effort to gear it up to the needs of the petroleum industry. Several contractors went bankrupt through involvement in the enterprise.

Since it was anticipated that only 5 years would be needed to develop the southern gasfields, compared with the much longer lead times later needed to develop the northern oilfields, the Ministry became disheartened and did not repeat the attempt. The companies, for their part operated through approved suppliers lists. These lists were of foreign (mostly U.S.) suppliers of proven performance. Given the nature of the dependent relationship in which the Government found itself, the whole situation reflected the fact that the pace of development was largely company determined. Had the relationship been more favourable to the Government, then they might have insisted that a certain proportion of all contracts be reserved for U.K. industry. In that situation some special effort would have been justified to gear U.K. suppliers up to the challenge.

The Government in 1964 were overconcerned with the macroeconomic impact of the oil and gas effort in the North Sea, and with the development of new high technology industries (e.g. computers) and tended to disregard the sectoral impact of the oil and gas industry. There was an uncritically favourable view of multinational enterprise taken by both the Government and the Opposition. At that time there was no experience of the consequences of Multinational disinvestment, such as was later provided by the Chrysler episode. The Government wished to develop the North Sea's oil and gas resources quickly. To this extent their interests overlapped with those of the oil companies, who wished to recoup their very large investment as soon as possible, and move into a condition of substantial profit. In this context, if established U.S. suppliers could provide the right quality of equipment and at the same time meet tight deadlines, then it was in the

interest of both the oil companies and the Government that they should do it, and it is hardly surprising therefore that no serious and sustained effort was made to gear up British engineering so as to meet the special requirements of the offshore supplies market.

1.3 Summary of Conclusions There were two problems which deterred reputable oil companies from the search for oil and gas prior to 1934. The first problem related to the ownership of oil and gas. These hydrocarbons exist in fluid form in reservoirs, and thus might lay beneath the land of several surface owners, any of whom up to that time could lay a claim to the proceeds of any consequent production. The second problem related to the difficulties associated with securing the necessary access for roads and pipelines from several surface owners. In 1934, the two problems were resolved by taking oil and gas into Crown ownership, and providing guaranteed access rights for Government licencees, subject to safeguards designed to compensate surface landowners for loss and disturbance and protect the environment. Prior to the Petroleum (Production) Act, 1934 any technically viable solution to the two problems of ownership and access was politically unacceptable, given the predominant view in Parliament that the rights of private property were sacrosanct. (Para 1.11)

Given the need to deal with the economically depressed conditions of the 1930's the National Government developed a system of tax reliefs and subsidies, known as 'managed capitalism' which involved the Government to a greater degree than ever before in the running of the national economy. Yet when one remembers that the introduction of Nationalisation as an industrial strategy had to wait till Labour came to power in 1945 with an overall

majority, it will be appreciated that the measures by which Crown ownership was extended over oil and gas in 1934 were very radical indeed, and went well beyond the range of measures covered by 'managed capitalism'. While reasons relating both to the economy and needs of national defence were advanced to justify these measures, those relating to defence predominated. Given the climate of public opinion in the middle 1930's the National Government felt that the risks associated with a formal rearmament programme were politically unacceptable. However, given the clear evidence of German measures aimed at fuel preparedness for War, it seemed prudent, given experience in the 1st World War, to respond to these measures with a British programme of economic and technical fuel preparedness, which was not visible to the public in the same way as formal rearmament. (Para 1.12)

The justification provided by the Marquess of Londonderry to the House of Lords in April 1934 for the Government's measures, shows clearly that Stage 1 of the Model derived from Hossain was in operation (i.e. that the Government were seeking to attract the oil companies into a search for oil and gas). Opposition to the measures was restricted to a small group of Conservative MP.'s and Peers, led by the Duke of Devonshire. The Duke represented the coalowning interest, who opposed the Government's proposals because these measures supported a fuel in competition with coal, and also because they feared that once oil and gas was taken into Crown ownership this would provide a precedent for taking coal into public ownship at a later date. These various opponents claimed that the Government's proposed measures were 'socialism' and even attempted to revive proposals first suggested by the Duke of Northumberland in 1917, which were designed to

stimulate an oil search without infringing the rights of private property. In 1934, as at the earlier date, these proposals were not technically viable. Parliamentary opponents of the Government's proposals sought to show that a covert relationship existed between the Government and vested interests (the oil companies) by probing Ministers on the source of their technical advice in formulating the Government's proposals. (1.13)

In 1935, the Regulations under which Government Licencees were to operate, were produced with great urgency by the Petroleum Department of the Board of Trade, notwithstanding the limited expertise available to the Petroleum Department, and Professor V.C. Illing of Imperial College, who together with his colleagues was the only independent source from which the Government could have sought advice, expressed the view that the Regulations were very skillfully prepared. This suggests that Illing and his colleagues were not consulted, making it likely that such advice was obtained either directly from the Oil Companies, or through the Institution of Petroleum Engineers (later the Institute of Petroleum), an institution funded by the Oil industry (Para 1.13).

These 1935 Regulations provided very generous terms under which the companies were to operate. Exploration Licencees were to be for 6 years and cover an area of 200 square miles. On conversion to a Mining (i.e. Production) Licence, the original area was halved- though the company could usually negotiate for possession of the most favoured half. Under these Mining Licencees, Crown Licencees held their rights for 50 years, and had the option to extend these for a further 25 years. There was no provision to renegotiate these terms during the duration of the Lease. A very generous

set of terms were provided for foreign capital, and a low royalty was to be paid. The aim was to stimulate the growth of exploration effort, not to secure revenue. Further stimulus to the exploration effort was provided, beyond the terms of these Regulations, by tax relief on motor fuels derived from indigeneous oils. (Para 1.13)

A comparison of contemporary licencing arrangements in Roumania and the U.S.A., demonstrates that the Administrative Allocation Licensing System introduced in the U.K. in 1934, was well suited to British conditions. Applications for Licences were evaluated by Civil Servants, who while ensuring that all the principal oil industry interests obtained a share of the allocation, were able to ensure that British interests in particular obtained a fair share. Thus the Government retained a power to discriminate against any particular company or companies in future allocations- a power which was used by the Labour Government after 1975 to discriminate against, or threaten to discriminate against, companies who did not 'negotiate' State participation in existing licences. This discriminatory process will be described in Chapter 4. As regards the normal non discriminatory application of the system, the companies were well pleased with the system, since it saved them the money expended on bidding for licences in the U.S.A., and this cash was then available as a contribution to their exploration expenses. (Para 1.14)

In 1964, a bipartisan rapid development policy was applied for the development of the southern North Sea gas fields. This arose from the view shared by both the Conservative and Labour Parties of the overriding need to

use the development of the North Sea as a means of providing a stimulus to the British economy, whose performance was so poor by comparison with those of our European neighbours. (Para 1.21)

Conditions in the Norwegian economy and society were so different, compared with those in Great Britain, that these conditions brought about a different policy in that country, namely slower development. The Norwegian decision to leave a greater part of their oil and gas in the ground, was based on a shrewd assessment of the benefits which would accrue from an escalation in energy prices. (Para 1.22).

Both Britain and Norway were highly dependnent on the oil companies in 1964, though Norwegian dependence was lessened in some measure by their policy of slow development. Apart from the massive finance needed to begin the development of the North Sea, marine petroleum technology, the essential expertise for the task, was a rare commodity, substantially in the hands of the 7 major oil companies, which meant that much of it was in U.S. hands. There was no possibility of developing a local expertise to equal that of companies in the short or medium term. (Para 1.23)

The legal dimension of the 1964 offshore regime was substantailly derived from its 1934 onshore predecessor, both because the earlier model and experience were readily available, and since the general terms provided were appropriate to the constraints under which the British Government had to operate in the mid Sixties. There were modifications to reflect the movement offshore (e.g. rules on navigation), and the length of a Production Licence

was reduced to 40 years compared with its 1934 counterpart. This duration still remained very generous, and there was still no provision for a renegotiation of terms before expiry of the Lease. A significant provision made the nationalised gas industry the sole purchaser of North Sea gas. The Administrative Allocation system was retained for just those reasons which had made it appropriate in 1934. (Para 1.23)

The level of dependence of the British Government on the oil companies meant that given their mutual interest in rapid development, the pace of work was largely company determined. A fiscal regime based on a 12½% royalty on the wellhead value of petroleum, plus the normal application of U.K. Corporation Tax assisted the companies to achieve a high rate of return on capital invested, commensurate with the risks they were taking. The companies took advantage of a combination of the normal operation of Corporation Tax, transfer pricing, a double taxation relief, in order to offset North Sea costs against their substantial expenditures outside the North Sea, including their foreign (i.e. non British) operations. (Para 1.23).

The division of economic rent derived from southern North Sea gas operations became the object of bargaining between the nationalised gas industry and the oil companies over the price to be paid the latter for their gas production. The settlement achieved gave the companies a higher rate of extraction than that actually required by the nationalised gas industry, so that they obtained some compensation through turnover for the low unit price per therm that they received. (Para 1.23)

Attempts by the Ministry of Power to stimulate the growth of a home based offshore supplies industry were not persisted with. Those British companies who did attempt to enter this market in the mid 1960's were often not successful. The oil companies preferred to use proven U.S. suppliers of oilfield equipment who delivered quality products to time. Since both the Government and the oil companies wanted rapid development, the provision of satisfactory equipment according to firm deadlines, was in their mutual interest. The British Government were more interested in the wider macroeconomic effect of the exploitation of the North Sea, and thus failed to appreciate the importance of the sectoral impact (i.e. in respect of offshore supplies). The time span needed for the development of southern North Sea gas of around 5 years, was also relatively short. All these reasons combined, contributing to the failure to gear up British industry to take full advantage of North Sea opportunities (Para 1.23).

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Chapter 2 The North Sea Delimitation Treaties; The Cross Boundary Agreements

2.1 Introduction Chapter 1 described how the character of the 1964 offshore regime was largely determined by the need to induce the oil companies and the financial institutions to invest the large sums of money, and the scarce technology, which were required for the rapid development of the oil and resources of the U.K. Continental Shelf. However, favourable conditions would not in themselves have been sufficient to secure that end. Unless the oil industry and its sources of external finance could be assured that Great Britain's jurisdiction over her own North Sea Sector was accepted by the other North Sea States, then they would not have been prepared to accept the operational and financial risks associated with a dispute over ownership, after they had once embarked upon the project. Thus the bargain agreed between the British Government and the oil industry had to be complemented by action to secure internationally recognised boundaries for a British Sector of the North Sea. The progress of investigations in the North Sea, already described in the previous Chapter, had by the early 1960's created a similar pressure on all the North Sea States, to create an international regime under which to exploit the oil and gas resources of the Region.

This present chapter is principally concerned with the negotiations whereby that international regime was set up on the basis of a division of the North Sea into National Sectors. (These negotiations will be covered in Para 2.2) Factors which operated against free access to the oil and gas resources of the Region, will first be explained in terms of Keohane and Nye's analysis of the erosion of the free seas regime. Factors which prevented the development of a European Regional Regime will also be briefly considered. The main emphasis will be placed upon the British approach to the negotiations,

showing how the bipartisan rapid development policy influenced Britain's playing of a strong negotiating hand. Two principles established in the Geneva U.N. Conference on the Law of the Sea, and consequently incorporated in the U.N. Convention on the Law of the Sea (1958) will be described. These two principles were well suited as the basis for a division of the North Sea into National Sectors, but it will be demonstrated that the negotiations were essentially a political matter, so that accession to the U.N. Convention on the Law of the Sea by the negotiating States was determined by a combination of geological and geographical factors, together with the stage reached in the negotiations. In order to appreciate the British negotiating stance, reference will be made to the relative strength and weakness in the negotiating positions of other North Sea States.

The distribution and extent of the oil and gas resources of the North Sea were largely uncertain throughout most of the negotiations, which were completed by August 1967, if one excepts the renegotiation of boundaries between Denmark, the Netherlands and West Germany (1971) which increased the West German share of the North Sea at the expense of those other two States, but in no way affected the jurisdiction of Great Britain over her own Sector. Uncertainty about the distribution and the extent of the resources to be exploited had two impacts upon the negotiations. Firstly, since there were no disputes over the ownership of known deposits, the negotiations were completed fairly rapidly. Secondly, as Birnie and Mason ⁽¹⁾ explain, the negotiations had something of the character of purchasing tickets in a lottery, except that the prizes which were unknown at the time of the draw had been determined geologically many millions of years earlier. It was this very uncertainty about the distribution of the oil and gas resources to be

allocated among the North Sea States which gave particular significance to the arrangements made between those States to manage any oil and gas deposits which were later found to straddle the previously negotiated Sector boundaries. (These arrangements, particularly those involving Great Britain and her North Sea neighbours, will be covered in Para 2.3).

As an introduction to the discussion of the cross boundary arrangements negotiated between States to manage deposits which lay partly within one Sector and partly in another, an explanation in simple terms will be given of Unitisation. Where two or more oil producers share access to a common reservoir, it will be demonstrated that their best interests are served by exploiting that reservoir co-operatively as a Unit (hence the term Unitisation) rather than by wasteful competition. It will be shown that just as Unitisation is the normal regime for two or more oil producers accessing a common oil and gas deposit, so the same logic applies with equal force to those North Sea States whose common Sector boundary cuts across an oil and gas deposit.

The need to reach agreement on cross boundary Unitisation was recognised at the time of the delimitation Treaties, and was reflected in a series of 'agreements to agree' on this issue, between the signatory States, in which they pledged themselves with varying degrees of commitment to seek a practical solution to the management of any oil and gas deposits which straddled Sector boundaries. A simple outline will be given both of these 'agreements to agree' and the arguments of international lawyers and others, on what the proper technical and legal bases of an international cross boundary Unitisation agreement ought to be. It was feared that while such

agreements were necessary for the efficient exploitation of oil and gas deposits which straddled Sector boundaries, they would in practice undermine the basis of the international regime in the North Sea, by affording too many circumstances in which one country would be entitled to intervene within the Sector of its neighbour. This would undermine the principle of national control within Sectors on which the regime was founded, and create the circumstances for future conflict between States. Unitisation involves co-operative activity, and such co-operative activity conflicts with the principle of national jurisdiction, which involves a separation of activities on a national basis.

Despite these fears, however, it will be demonstrated by reference to the Frigg Field Agreement (1976), ⁽²⁾ the first full international cross boundary Unitisation Agreement, which was signed between Great Britain and Norway, that the many economic, legal, technical and managerial problems faced were resolved between the two countries in a practical fashion. This was because the common interest of both Governments in reaching a settlement was so great. Given their almost equal interest in the Frigg Field, and notwithstanding some diminution of national authority arising from the co-operative nature of the enterprise, the two countries were able substantially to maintain the principle of national control within Sectors, and thus reduced the prospects for any future conflict between themselves. This they did by a balanced and mutually exclusive allocation of duties between them, along lines which had already proved effective in the Ekofisk Pipeline Agreement. ⁽³⁾

Richard Young ⁽⁴⁾ reminds us that the delimitation of the North Sea Sector boundaries was an essentially political matter, but points out that due weight has to be given to the impact of international law on the negotiations. A State will adopt any principle of international law which coincides with its interests and several States may adopt such a principle if it assists them to secure a mutually acceptable adjustment of their interests. However, the fact that negotiations will often be concluded without reference to any principle whatsoever, as in the case of the Denmark, Netherlands, West Germany renegotiations of North Sea territory (1971) serves to emphasise that negotiations are a political process for adjusting interests. That said, the two UNCLOS principles (1958), were a significant factor in the negotiation of the North Sea Sector boundaries. The geological and geographical features of the North Sea, and the manner in which they might be interpreted or treated as special factors by the negotiating States, could in turn have affected the outcome for these States through their impact on the application of the two principles. For this reason, an outline of the geological and geographical features of the North Sea in Para 2.11 precedes an outline of the two principles in Para 2.12, the whole thus forming a proper basis for consideration of the negotiating process in Para 2.2.

2.11 Geological and Geographical Features of the North Sea Young (in the work previously cited) reminds us that the North Sea is far more than an oilfield covered by water, since for Centuries it has been one of the major fishing regions of the world, and has provided the trade routes between the ports of N.W. Europe. The North Sea covers an area of approximately 220,000 square miles between Great Britain and N.W. Europe. The northernmost limit separating it from the Atlantic is latitude 62°N or alternatively a line from

the northernmost Shetland Islands, east to the Norwegian coast. On the east, the North Sea is separated from the Skaggerak, by a line running from Cape Lindesnaes in Norway to Cape Hantsholm in Denmark, and in the south by a line in the Straits of Dover, which is sometimes defined as running from the South Foreland on the English coast, to Cap Griz Nez in France. These limits are broadly similar to those which were laid down in the Convention of 6th May 1882, for Regulating the Policing of North Sea Fisheries. (5) The extent of the North Sea is shown in the map which forms Appendix 1 to this Chapter, which gives the boundaries of the national Sectors as finally delimited.

The North Sea is rarely deep. The 100 fathom line is north of 62°N, while south of 57°N is within 50 fathoms. Brower⁽⁶⁾ observed that if Shell Centre Tower, which stands 351 ft. above the ground were to be placed almost anywhere on the North Sea seabed, then it would almost always extend above the surface. There are only a few significant depressions in the seabed which run counter to this observation, but the view taken by Great Britain and Norway of the geological character of one of these depressions, that known as the Norwegian (or Graben) Trough, was to prove a most important factor in the negotiation of their Sector boundary.

The Norwegian Trough, which as its name implies is close to the Norwegian coasts, varies in depth from 100 to 300 fathoms, and in width from 20 to 50 nautical miles. The rim of the Norwegian Trough is not really a shelf edge in the proper sense, but a slash in the seabed formed by glacial action similar to that observed on the Norwegian mainland.⁽⁷⁾ A paper prepared for UNCLOS 1(1958) ⁽⁸⁾ which stated that the Norwegian Trough forms part of the Continental Shelf from a morphogenic point of view, and pointed out that

it is separated from the Atlantic on the north by a sill at 150 fathoms, formed the scientific basis for the Norwegian claim that their Continental Shelf extended across the Norwegian Trough to that boundary line which they later agreed with Great Britain.

UNCLOS 1 had defined the Continental Shelf as extending from the coast to a depth of 200 metres, though an extension of this depth would be acceptable where the necessary technology existed to secure the exploitation of resources. At that time (1958), 200 metres was held to be depth at which existing and shortly anticipated technology could reasonably be expected to operate. Thus interest did not seriously extend to greater depths and certainly not to the deep seabed work presently envisaged. Of course, bad weather and extremes of temperature may increase the costs and hazards of working at even quite shallow depths. Thus while the Norwegian Trough did not at that time qualify as Continental Shelf in terms of either depth or exploitability, there were sound geological grounds for the contrary view that it forms no more than an interruption in the Norwegian Continental Shelf, which extends seaward to meet its British counterpart. Moreover, given the subsequent development of technology, it is possible to see with hindsight, that the greater the extent to which a definition could be based upon geological factors, the more likely it was to prove stable in character.

The Continental Shelf will often provide a favourable environment for the existence of those sediments in which deposits of oil and gas occur, and a great deal of the North Sea fits this pattern. Having set out some of the principal geological and geographical factors of the North Sea which were to have an important impact on the negotiation of Sector boundaries, the two

UNCLOS principles which contributed to a political settlement of those boundaries will be set out, before considering the negotiating process by which they were arrived at. The discussion of that negotiating process in Para 2.2 will open with a consideration of the erosion of the free seas regime, and include an explanation of why a Regional Regime amongst European States, was not a serious prospect for the North Sea. The two UNCLOS principles were designed for a division of territory between States on a national basis.

2.12 The Two UNCLOS Principles After eight years work by the U.N. Law Commission, and the U.N. Conference on the Law of the Sea (1958), the two principles were incorporated in the U.N. Convention on the Law of the Sea, and available as the basis for a division of Continental Shelf between States. The two principles were set out in Article 6 of the Convention as follows:

- (1) The Median Line Principle Where the Continental Shelf is adjacent to the territories of two or more States, whose coasts are opposite each other, the boundary of the Continental Shelf appertaining to such States shall be determined between them. In the absence of such agreement, and unless another boundary line is justified by special circumstances, the boundary is the Median Line, every point of which is equidistant from the nearest point of the base lines from which the breadth of the territorial sea is measured.
- (2) The Equidistance Principle Where the Continental Shelf is adjacent to the territories of two States, the boundary of the Continental Shelf shall be determined by agreement between them. In the absence of such agreement, and

unless another boundary line is justified by special circumstances, the boundary line shall be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea is measured.

Article 6 further stated:

'In determining the boundaries of the Continental Shelf, any lines which are drawn in accordance with the principles set out... should be determined with reference to charts and geographical features, as they exist at a particular date, and reference should be made to fixed permanent identifiable points on land'.

These two principles were the unchallenged legal bases for Continental Shelf delimitation till 1969, when the International Court of Justice advanced some additional ideas to assist Denmark, the Netherlands and West Germany to resolve the North Sea Dispute over the renegotiation of their North Sea 'territory'. While none of these ideas formed the basis for the actual settlement of that dispute in 1971, which was resolved without reference to any principle whatsoever, the Court did emphasize that no State which had not acceded to the U.N. Convention (in this instance West Germany) was under any obligation to accept the two principles as the basis for delimiting the boundary of its Continental Shelf.⁽⁹⁾

2.2 The Negotiations In 1945, President Truman issued a Proclamation to the effect that the 'United States regards the natural resources of the seabed of the Continental Shelf beneath the high seas, but contiguous to the coasts of

the United States, subject to its jurisdiction and control'. In this context, 'natural resources of the seabed' included mineral resources which were located under the seabed. As Keohane and Nye explain, from the 1880's onwards, the concept of the free access to the oceans, combined with the complementary system of Free Trade served the interests of the United Kingdom, which possessed the naval power to enforce compliance with this regime, should this prove necessary. This approach was generally acceptable both to the other European States and to the United States. With her victory in World War I, Great Britain re-established her naval superiority, though under the Naval Treaty of 1922 this was somewhat diminished when the relative strengths of the British, U.S., and Japanese navies were established in the proportions 5:5:3, a formal recognition of the power of Japan which was a Pacific rather than a global power. The United States generally accepted and supported the free seas principle, with the exception that Britain had conceded to her rights to intervene in order to carry out anti smuggling operations.

With the decline of British power from 1945 onwards, the United States still maintained a formal commitment to the free seas principle, however the maintenance of this principle was in conflict with the Truman Proclamation. The exploitation of mineral resources requires certainty of title if it is to secure the necessary financial backing, since investors will not be prepared to take risks, when if later successful, their rights are likely to be challenged by others. The free seas regime provided for the free movement of commerce across the World's oceans, while the complementary system of Free Trade provided for the free passage of goods across national frontiers, unhindered by tariff barriers, and by a natural extension of the liberal

principle of free access, the free seas regime thus implied free access to the mineral resources of the Continental Shelf. If large sums were spent on determining the location and nature of those mineral resources, what under this natural extension of the free seas regime, was then to prevent others from exploiting deposits once they had been discovered? The situation was brought to a head in 1945, not merely by advances in oil technology which created pressure from the US oil industry to secure certainty of title to the 'natural resources of the seabed... contiguous to the coasts of the United States' but also because parallel advances in fishing technology created a demand from U.S. fishing interests for action to secure for them exclusive access to fish stocks in offshore areas' contiguous to the coasts of the United States, subject to its jurisdiction and control'. Thus there was a very real conflict between on the one hand the free seas regime, and on the other hand, the Truman Declaration (1945) which created the conditions necessary for investment to secure the exploitation of the oil and gas resources of the U.S. Continental Shelf.

The Truman Declaration (1945) had an ongoing effect in that it encouraged various Latin American States to extend their territorial sea, and from 1945 to 1967, Keohane and Nye describe the situation as being a strong quasi regime, which means that while the U.S. and other States continued to give general support to the free seas concept, it was still being generally weakened. The statement of Arvid Pardo, Maltese Ambassador to the U.N. in 1967, emphasised that the untapped resources of the seabed were an important source of new wealth. This may be regarded as a point after which there was a quickening of the process whereby the oceans were to become less of a free highway, and far more a series of enclosed national reserves. Keohane and

Nye⁽¹⁰⁾ provide a useful chart to stress this process of regime change:

INTERNATIONAL REGIMES IN THE OCEANS POLICY ISSUE AREA, 1920-1975

<u>Period</u>	<u>Years</u>	<u>Regime Situation</u>	<u>Action at Beginning of Period</u>
I	1920-1945	Free seas regime	Britain reasserts leadership after World War I.
II	1946-1966	Strong quasi regime	1945 Truman Declaration and Latin American extensions.
III	1967-1975	Weak quasi regime	Pardo's 1967 U.N. Speech.

By the mid 1960's when the negotiations began over the formation of an international regime for the North Sea, the process of regime change initiated by the Truman Declaration (1945), and the realisation of the importance of the resources laying beneath the seabed, were so far advanced as to make a regime for a free access to the oil and gas resources of the North Seas a non starter in political terms, even though economic arguments have recently been advanced for free access to deep seabed resources.⁽¹¹⁾ If the two UNCLOS principles were applied to a settlement of the North Sea Sector boundaries without any allowance for special factors, then the outcome for the various North Sea States would have been as follows:-

<u>Country</u>	<u>% of North Sea</u>	<u>Other Oil and Gas Prospects Mid Sixties</u>	<u>Other Energy</u>
Great Britain	Somewhat less than 50%	Prospects on other coasts	Abundant coal
Norway	About 25%	None	Abundant hydro-electricity
Denmark	About 10%	Prospects in Greenland and Faeroes	Limited peat

Cont/...

Netherlands	About 10% with excellent gas prospects.	Some onshore oil and gas.	Some coal
West Germany	About 5%	Some onshore oil and gas.	Coal
France	Negligible	Atlantic coast	Coal
Belgium	Negligible	None	Coal

Under a straight application of the two principles, well over 80% of the North Sea would fall to three States, Great Britain, Norway and Denmark, none of which were members of the E.E.C. at the time of the negotiations, and one of which, Norway never did join the Community. Britain did exceptionally well with just under 50% of the region; Denmark did well for a small country; Norway had an appropriate share for a country with an extensive coastline. Of the six countries that were E.E.C. members at the time, Italy was a Mediterranean State with only limited indigeneous supplies of natural gas, Luxemburg was landlocked, Belgium and France fared very badly and West Germany received a very poor share relative to her economic strength, as a result of the impact of applying the two principles to her concave coastline. By contrast, the Netherlands was the one Community member that did well. She received a 10% share of the 'territory' which was appropriate for her size and economic importance, and the value of this share was enhanced by virtue of the fact that it contained good gas prospects. Thus 5 out of the 6 E.E.C. member States had good reason to favour the formation of a European Regional Regime, probably run from Brussels, which accorded rights and benefits to all member States, and was not based on the application of the two principles which accorded rights of exploitation to separate States with North Sea coastlines. However, since the majority of the States who benefitted from the application of the two principles were outside the Community at the

time of the negotiations to establish an international regime for the exploitation of the oil and gas resources of the North Sea, no opportunities existed for disadvantages E.E.C. members to apply leverage, by offering to grant Denmark, Norway and Great Britain benefits in other E.E.C. policy areas, linked to a regional solution for the exploitation of those oil and gas resources. Thus a European Regional Regime was not a serious possibility.

States negotiating National Sector boundaries were engaged in the traditional diplomatic activity of drawing lines on a map, so as mutually to agree upon access to new territory. With this difference; in this case, their rights to this North Sea 'territory' were not fully sovereign. Historic animosities played no part in the negotiations, as they did in the Rockall dispute between Great Britain and Ireland.⁽¹²⁾ The negotiations were largely complete before the Arab-Israeli War (1967) and finalised well before the world oil crises (1973), so that the heightened perception of the value of oil and gas resources, which followed from the latter event, played no part in the negotiations. The Treaties in which the Sector boundaries were established, are shown in Appendix 2. For Britain, as the only State on the western side of the North Sea, the Equidistance principle did not apply. Thus with only the Median Line principle applied, Britain stood to gain nearly 50% of the region. Had Britain stood out for the view that the Norwegian Trough did not constitute part of the Continental Shelf, then she could have claimed about 70% of the North Sea. However, as Grisell explains,⁽¹³⁾ all the States involved in the negotiations had a strong mutual interest in a rapid and amicable settlement, in order to get investment started. For this reason, a claim by Britain for 70% would have

negated the object of rapid development, as well as having adverse effects in other respects. As has already been shown, Norway had sound geological grounds for her view that the Continental Shelf extended across the Norwegian Trough to the Median Line. A dispute in the North Sea would have been a very strong general disincentive to investment, especially given the large area involved, and in any case, no investor would have been prepared to invest in the area in dispute, which might in due course have to be conceded to Norway. Thus it was, that the balance of interests, favoured acceptance of the Norwegian view.

For these reasons, not only Britain, but also Denmark, accepted the Norwegian view that Norway's Continental Shelf stretched across the Norwegian Trough to the Median Line. Both countries also took account of the fact that Norway was both a N.A.T.O. partner and a long term friend, as well as a neighbour from whom they might in the future require some favour. Thus a combination of economic self interest, a desire to maintain friendship with Norway, and a sense of fairplay, combined to justify both Britain and Denmark, to reach their settlement with Norway in line with that country's view of what constituted her rightful share of the North Sea.

Great Britain ratified the U.N. Convention on the Law of the Sea (and thus the Continental Shelf Convention), after the passage of the Continental Shelf Act, 1964. The Act was passed under a Conservative Government, which was almost immediately replaced by a Labour Administration. On the 2nd Reading of the Continental Shelf Bill in the Lords, Lord Shackleton, Labour's spokesman had observed that the Norwegian Trough was 800 metres deep, and thus did not form part of the Continental Shelf. Such circumstances must

certainly be to the advantage of Great Britain, as they would surely increase her share of the North Sea, through the application of the Median Line principle. After some subsequent behind the scenes discussions with the Government side, in which the basis of the friendly discussions with Norway then proceeding were doubtless explained to him, Lord Shackleton shifted his position. He then stated that he now appreciated that the Norwegian Trough was only 800 metres deep in parts, and that for the most part its depth did not exceed 200 metres. On this basis it was quite reasonable to regard the Norwegian Trough as Continental Shelf. For this reason it becomes clear that both the Conservative and Labour Parties, who were in accord on the need for rapid development (as shown in Chapter 1) now moved into alignment further, by favouring the same approach to the negotiations with Norway. For her part, Norway had declared that her Continental Shelf extended to the Median Line, as early as June 1963.⁽¹⁴⁾ However, Norway carefully avoided following up this unilateral act by accession to the U.N. Convention on the Law of the Sea, and only did so once all her boundary negotiations were completed, since earlier accession to the Convention might have given some credence to the alternative view of the Norwegian Trough and the Continental Shelf. This demonstrates that accession to the U.N. Convention on the Law of the Sea, was determined for States according to the stage of the negotiations, and the impact of geological and geographical factors on the two principles, and as such reinforces the view that the negotiations were essentially a political matter rather than a question of accepting a particular legal view of the boundary issue.

Britain later gained an unforeseen benefit for herself, by settling her Sector boundaries with Denmark and the Netherlands on the Median Line

principle. West Germany, dissatisfied with the share of the North Sea she had received under Treaties with these States in 1964/1965, claimed an improved and fairer share, consistent with her role as a North Sea coastal State, and in line with the extent of her coastline. There then arose what became known as the North Sea dispute. Subsequently, when a renegotiation of boundaries took place to compensate Germany for her poor share of the North Sea, this compensation was only at the expense of Denmark and the Netherlands, since their sectors were adjacent to the West German Sector. Britain's role, was as a result, confined to recognising a reallocation of 'territory' amongst these three neighbours.

The circumstances surrounding the North Sea dispute are as follows. The Sector obtained by West Germany, in Treaties with the Netherlands and Denmark, in December 1964 and June 1965 respectively, was only 5% of the area of the North Sea, since this allocation was based upon the application of the Equidistance (or Adjacency) principle to West Germany's concave coastline. West Germany was a powerful State in economic terms, as a consequence of the economic miracle, but her political strength was not congruent with this economic position, in view of Germany's defeat in World War II. German dissatisfaction was reflected in her refusal to accede to the U.N. Convention on the Law of the Sea, which contained the Equidistance principle. When the settlement of the North Sea dispute was achieved in 1971, it modestly increased the German share of the North Sea, without reference to any principle, and at the expense of Denmark and the Netherlands.

Britain signed the U.N. Convention on the Law of the Sea at the outset of her negotiating process, because the Median Line principle, which gave her nearly half of the North Sea, was fully in accord with her interests. Norway only acceded to the Convention, when all risk of an adverse interpretation of the Median Line principle in respect of the Norwegian Trough had been removed. West Germany never acceded to the U.N. Convention on the Law of the Sea, as to have done so would have implied acceptance of the Equidistance principle, and limited her ability to secure an improved Sector. The Netherlands signed midway in her negotiating process. Belgium and France, who did very badly in terms of National Sectors, and whose interests would have been best served by a Regional Regime, never did accede to the U.N. Convention on the Law of the Sea.

2.3 The Cross Boundary Arrangements The modern oil industry may be said to have started with the drilling of the Drake well in Pennsylvania in 1854. In the early days in the U.S. and later still in other countries, oilwells were not spaced out as they are today, but clustered together, so that photographs taken in those days give oilfields the appearance of forests. At first, it was not realised that excessive drilling and production led to a premature drop in reservoir pressure, a consequent sharp decline in the rate of production and a reduction in the ultimate quantity of oil produced from the reservoir. However, even as this situation became clear to oil producers, they continued to drill and produce competitively with one another in those cases where they shared access to a common reservoir. Each such producer justified his own action by reference to the law of capture, an ancient legal principle derived from access to underground water resources, even though such underground water resources were renewed from springs, while oil and gas

resources were finite. As a result of this folly, short periods of wasteful overproduction were followed by equally sudden slumps in production. The first person to propose a solution to this problem was Max W. Ball (1916) of the U.S. Bureau of Mines, who suggested that there should be voluntary agreements between oil and gas producers accessing the same oil and gas reservoir, so as to secure efficient and economic production. Ball also suggested that steps should be taken to reduce the number of producers through changes in the law. Unfortunately, he was somewhat in advance of his time and nothing came immediately of his proposals.

In 1924, the petroleum engineer Henry L. Doherty suggested an idea which at the time seemed astounding to many in the oil industry.⁽¹⁵⁾ Some companies were then already attempting to co-operate, as for example Shell and Standard of California in the East Coalinga Field in California. Building on this basis, Doherty suggested that each oil and gas reservoir should be treated as a single Unit for the purposes of management. Later, Doherty (1926) was among the pioneers of systems being developed to stimulate fresh production from exhausted reservoirs, by injecting gas into them to restore pressure. Doherty's 1924 idea for treating each oil and gas reservoir as a single Unit for the purpose of management, stressed the benefits to be gained all round through co-operation between oil producers. Very soon it was appreciated that through such measures as appointing a common operator for all the owners, by agreeing to prorate the costs and benefits of the activity, and by applying sound engineering principles to the operations, the advantages for all concerned were far greater than any which might be obtained through wasteful competition. Because of the benefits which arose from applying Doherty's original idea of treating an oil and gas reservoir as a Unit, the

regime developed for the common management of an oil and gas reservoir accessed by several producers was termed Unitisation and the agreements establishing these co-operative arrangements were termed Unitisation agreements. Within each National Sector of the North Sea, oil companies holding contiguous Licence Blocks naturally applied these proven methods of co-operation from the outset of their operations.

It was agreed at the time of the Delimitation Treaties, that before long cases would arise where a boundary line was found to cut across an oil and gas reservoir, and that if effective Unitisation were to be applied, then agreement between the countries involved would be essential, so as to provide a proper framework for co-operation between their respective concessionaires. As a result, the North Sea States made a series of statements of intention to agree on this problem should it arise. They did this however, with varying degrees of commitment. These statements of intention to reach agreement on the cross boundary problem became collectively known as the 'agreements to agree' and a list of them is provided by Birnie and Mason.⁽¹⁶⁾ Here, consideration of the 'agreements to agree' is restricted to those which involved Great Britain. In 1965, it seemed quite probable that gas deposits might be found which straddled the boundary then settled between Great Britain and the Netherlands, so the two countries set out in some detail how they intended to proceed in the event of this occurring. This they did in a supplemental agreement to their Delimitation Treaty. This supplemental agreement stated:

Article 1 'if any single geological, mineral oil, or natural gas structure or field, which is situated wholly on one side of the dividing line is exploitable wholly or in part from the other side of the dividing line, the contracting parties will seek to reach agreement as to the manner in which the structure or the field, shall most effectively be exploited, and the manner in which the costs and proceeds relating thereto shall be apportioned, after having invited the licencees concerned (i.e. their respective concessionaires) to submit agreed proposals to this effect.

Article 2 Establishes that the basic principle of an agreement would be 'to achieve technical effectiveness and the avoidance of dangerous competitive drilling' and further provides for the appointment of an arbitrator in the event of the two sides failing to agree.

In her Delimitation Treaty with Norway, Britain pledged herself to seek agreement on cross boundary Unitisation, should this be required, but did not actually pledge herself to achieve it. However, both countries agreed to involve their licencees in the process of seeking agreement. This was a recognition of the fact that the framework achieved was one within which those licencees had to operate. It also took account of the expertise of those licences, which meant that they had a valuable input to make to an effective settlement of the issue.

In her Delimitation Treaty with Denmark, Britain pledged herself once again to seek agreement rather than to achieve it. Too much should not be made of this distinction in view of the point already made, that in such an event both countries involved would have such a strong interest in achieving a settlement. Strangely, in view of the important role for licencees recognised in all the other Delimitation Treaties, and the subsequent crucial part played by licencees in the Frigg Field Agreement (1976), the Danes refused to include any provision for consulting licencees in 'agreements to agree' to which they were parties. There is no doubt that the Danish Government fully appreciated how important it would be to consult with licencees in reaching agreements with Denmark's neighbours for the exploitation of any oil and gas deposits which straddled her North Sea boundary. Indeed, the Danes may well have feared that given the expertise possessed by these licencees, they would probably prove the dominant influence on the shaping of any cross boundary agreement. Thus the Danes probably refused to commit themselves to such a consultation prior to the event, in order to stress the primacy of the role which they hoped a Danish Government would take, should cross boundary negotiations prove necessary.

In her final delimitation Treaty, with West Germany, Great Britain (1971) agreed to approach cross boundary Unitisation, should it prove necessary, in a manner essentially similar to that incorporated in the Anglo Dutch Treaty (1965).

All these 'agreements to agree' naturally stimulated arguments, between international-lawyers and others, on what the proper legal and technical

bases ought to be. In some respects, the considerations raised in these discussions were rather generalised in the case of legal points, or contrasted somewhat with the actual solutions achieved in the Frigg Field Agreement (1976), the first full cross boundary Unitisation agreement, which was negotiated between Norway and Great Britain. In order to point out the difference between these technical and legal considerations and the political adjustment of interests between Norway and Great Britain contained in that agreement, the arguments of international lawyers and others will be briefly established.

The legal considerations are set out in two articles by William T. Onorato.^(17,18) Onorato outlines the development of the domestic law of the petroleum producing countries as it evolved in parallel with the system of Unitisation. He deals in particular with the central question of apportionment, and shows how its treatment reflects a set of correlative rights and duties. These prove to be the equivalent of Oran Young's Rights and Liability Rules,⁽¹⁹⁾ a 'set of economic and social relations defining the position of an individual actor with respect to the utilization of scarce resources'. Such correlative rights and duties, in respect of Unitisation, are designed to protect the common interest against the selfish or irresponsible action of one of the partners. To this basis derived from the domestic petroleum laws of the petroleum producing countries, Onorato adds other concepts taken from international agreements relating to shared access by countries to natural resources, such as the Czech-West German agreement on the mining of cross border coal deposits, or the various agreements on access to fishing stocks, which latter resources are mobile yet move in determined patterns. In respect of apportionment he expresses the view that such an

agreement exists already in the Ems Dollard Agreement, between West Germany and the Netherlands.⁽²⁰⁾ James E. Horigan, addressing the Society of Petroleum Engineers⁽²¹⁾ observed that the Anglo Dutch Agreement(1965) contained no definite principles of apportionment, and doubted if any arbitrator would be able to resolve a dispute on the matter, while at the same time achieving a result which was efficient from an engineering standpoint. In this, Horigan failed to take proper account of the strong common interest which States would have in reaching an agreement on efficient cross boundary Unitisation.

The legal principles covered by Onorato certainly encapsulated much experience from situations analogous to the negotiations of a cross boundary Unitisation agreement in the North Sea. However, valuable as these principles were, they did not in themselves constitute such an agreement. At the time when Onorato was writing, he had the situation in the North Sea very much in mind, yet he failed to realise how fully that experience which the North Sea States had already acquired in dealing with simpler cross boundary problems, might provide a relevant contribution to the solution of the complex problems of cross boundary Unitisation in the region. Indeed, that this experience did make such a contribution, will shortly be demonstrated by showing that the Frigg Field Agreement (1976), the first full cross boundary Unitisation agreement, was based upon the approach which both Great Britain and Norway had already found mutually satisfactory in the Ekofisk Pipeline Agreement (1973).

The Ekofisk Pipeline Agreement (1973), arose from the need to manage the Greater Ekofisk Development. Ekofisk, which lays entirely in the Norwegian Sector, consisted of some 22 platforms feeding into a central complex from

instances of up to 18km away, in addition to which the Cod Field, some 75km away, also fed into this same central complex. The Norwegians, given that they did not require any of the oil or gas which might be produced for their domestic economy, decided to sell the gas produced to West Germany, and the oil to the U.K., subject to the proviso that they would be able to draw off any quantities they might require for their own use, after arrival in these markets. Based on this reasoning, a gas pipeline was to be built to Emden, and an oil pipeline to Teesside. The Norwegian Government took a major share in both these enterprises through Statoil, their National Oil Company. But an oil pipeline with Norwegian ownership, passing through the British Sector of the North Sea, to discharge crude oil in a terminal in Great Britain, presented the problem of determining which country's authority was to apply in the various aspects of the enterprise, and how possible conflicts between British and Norwegian authority might be minimised. This problem was reflected in seeking answers to the following questions. Was British or Norwegian law to apply to the pipeline? Who was to tax the crude oil passing through the terminal? Was the ownership of the terminal to be British or Norwegian? How were health, safety, welfare and pollution matters to be handled?

In approaching the solution of these problems, the British and Norwegian negotiators were conscious of the significance of four factors. Firstly, their authority over their North Sea Sectors was less than that they each exercised over their land territory, which fact was indicated by the need for domestic legislation to establish just what powers they respectively intended to employ within their separate areas. The sea did not yet consist of totally exclusive national reserves. Secondly, the British were anxious to

preserve their national right to manage their own sector, and Norway had an equal interest in preserving Britain's position in this respect, so as to preserve a similar right for herself within her own territory. Thirdly, a settlement had to reconcile this second factor with the balance of commercial interest in the enterprise. This meant, that while the crude oil was being delivered to a terminal in Teesside, it was oil originally produced in the Norwegian Sector and transported through a Norwegian owned pipeline, so that the principal stake in the enterprise was Norwegian, even though the lesser British interest was not inconsiderable. Fourthly, whatever arrangements were made, they had to be workable from the standpoint of the oil industry. All these factors were similar to those which would have to be considered in formulating a cross boundary Unitisation agreement, always remembering that the technical problems involved in Unitisation would add a further layer of complexity.

For the Ekofisk pipeline it was agreed, that the pipeline company being Norwegian, with a trading branch in the U.K. should be taxable by the Norwegian Government in accordance with Norwegian tax law, while the terminal company should be a U.K. company, whose profits were taxable in the U.K. only. The pipeline, as distinct from the pipeline company, was to be subject to both British and Norwegian Civil and Criminal Law, with the proviso that British arrangements with respect to conflict of laws were to apply. This reflected the fact that though the pipeline was Norwegian it passed through the British Sector. Accordingly, in case of a dispute the British acquired a special advantage. In similar fashion, health, safety and pollution matters were to be settled in accordance with both British and Norwegian Regulations. An Arbitration Panel was appointed, with one member from both the British and

Norwegian side, and one neutral member acceptable to both Governments. The whole arrangement was mutually balanced, satisfied both sides, and worked very well, most probably because both of the countries involved wanted it to work, rather than because of any intrinsic virtues in the arrangements agreed.

The Frigg Field is a large gas reservoir which stretches across the sector boundary agreed between Great Britain and Norway in 1965. The Frigg Field Agreement (1976) was the first full cross boundary agreement in the North Sea, in that it included arrangements for Unitisation. The agreement is often referred to as a watershed agreement⁽²²⁾ both because it is the first of its type, and because it set the pattern for all future cross boundary co-operation between Britain and Norway. The interests of the two countries were more evenly balanced in the Frigg Field than in the Ekofisk pipeline negotiation, in that the field was physically located in both sectors, and it was agreed that the gas would be transmitted in two pipelines (one British and one Norwegian owned) to St. Fergus on the Scottish coast. Moreover, the interests of the two countries were interdependent to a very great extent, since Unitisation was involved, and as has already been demonstrated, Unitisation as a regime arose originally from a recognition of the interdependence of producers accessing a common reservoir.

Basically, the Frigg Field Agreement(1976) fell under three headings: (1) Exploitation of the Frigg Field, consisting primarily of the arrangements for Unitisation, but also dealing with arrangements for establishing safety measures and providing guidelines on the rights of officials.

(2) Transmission of gas from the Frigg Field reservoir, dealing principally with the pipelines, but similarly providing guidelines on the rights of officials from both countries and (3) General provisions. In this, the Governments commit themselves to agree on pollution and to set up the Frigg Field Consultative Committee, to oversee implementation. It also provides, inter alia, for the establishment of an Arbitral Panel to resolve those issues which cannot be settled by the Frigg Field Consultative Committee. These three main sections are preceded by an introduction which repeats the 1965 commitment of both countries to secure agreement on all problems.

The negotiators looked to the earlier Ekofisk Agreement (1973) which had proved satisfactory to both sides, as a contribution to resolving the more complex problems they faced in the Frigg Field. Since the Ekofisk Agreement was concerned with the problems of managing a pipeline, those sections of the Frigg Field Agreement which relate to the problems of the two pipelines to St. Fergus have a direct similarity with the Ekofisk pipeline arrangements. However, since the interests of both countries were more equal in the Frigg Field, the rights of each country are more balanced. For example, one pipeline was to be owned by the U.K. and the other by Norway, although both pipelines were transmitting gas to the U.K. In general, the negotiators tried to achieve not only a balance between the rights of each country, but attempted to make these rights mutually exclusive. On the whole they were successful and provided a framework which permitted the oil companies to establish most of the technical arrangements required, provided that the Governments were properly informed of the decisions taken. Thus licencees were required to enter into agreements on exploitation and submit these to the two Governments for approval. Within this framework the national right

to manage was substantially maintained, though there was some diminution of the rights of each country within its own sector. For example, a Norwegian licensee can drill a well in the British Sector for the purposes of reserve assessment, and a British licensee can take similar action in the Norwegian Sector. In extreme circumstances, an Inspector from one country may enforce safety measures within the other country's sector. However such a modest diminution of national authority is of no great consequence, given that Article 29 of the Frigg Field Agreement formally states that 'nothing in this agreement will effect the jurisdiction of each State over its Continental Shelf'. The Department of Energy⁽²³⁾ stated that 'the agreement for the Frigg Field gas field (1976) has proved an efficient and flexible document, and has enabled the two Governments in the Frigg Field Consultative Commission to regulate the field through the development and into the production phase'.

A reading of successive volumes of the U.K. Department of Energy's "Development of the oil and gas resources of the United Kingdom" suggests a progressively interdependent relationship in the North Sea between Great Britain and Norway. Agreements on the Statfjord and Murchison Fields were signed in Oslo on 16th October 1979 and in the year ending June 1980, licensees in both fields concluded an agreement between themselves providing for the Unitisation of the fields, their development and the apportionment of reserves. The Oslo Agreement(1979) provided for an initial apportionment of Statfjord of 16% to Great Britain and 84% to Norway, but further provided for a reapportionment of these reserves on first production. Thus, as in the Frigg Field Agreement (1976), provision was made for the reapportionment of reserves as more data became available. The Oslo Agreement built broadly

upon the same framework as that successfully established for handling Frigg Field gas. The interdependence of Great Britain and Norway is emphasised by the existence of the U.K. Norwegian Consultative Committee. This Committee, headed by responsible Ministers from each country, meets on a regular basis to discuss matters of common interest, and spends much of its time discussing the Median Line fields. Under this Committee, there is a Working Group on Safety and Related Matters, which covers offshore safety and contingency planning. The licencees themselves have set up safety areas, given the names of colours (red, orange, blue) which cross national sector boundaries, and within which co-ordinated planning takes place to deal with possible emergencies. Thus there is clear evidence, that while the National Sector Regimes in the North Sea remain largely distinct, the nature of the overall task being carried out, necessarily imposes a considerable measure of interdependence.

Further evidence suggests⁽²⁴⁾ that where problems arise within the British Sector of the North Sea, these are far more likely to develop from the conflicting interests of the many British Agencies which operate within the British Sector, than from any limited action taken by the Norwegian authorities within British 'territory'. Where the Norwegians do take action within the British Sector however, this is often more effective than comparable British action. Norwegian Safety Inspector, for instance, will often drop in without prior warning, while their British counterparts give several hours warning. This may be due to the fact that in Norway the Ministry of Petroleum and Energy does not have a direct day to day practical concern with offshore matters, which are the function of the Norwegian Ministry of Labour. This derives from the Norwegian Government's fear that

too close a connection between the Ministry of Petroleum and Energy on such day to day matters, might prove detrimental to the country's best interests.

2.4 Summary of Conclusions

A weakening of the Free seas regime, initiated by the Truman Declaration (1945), had progressed so far by the early 1960's that free access to the oil and gas resources of the North Sea was not a viable political option, especially having regard for the need to provide a certain legal title to those resources in order to secure the investment needed for their exploitation. The process was by then well advanced which was to turn those Oceans into national preserves, rather than an open highway, a change signalled by the Pardo Statement to the United Nations (1967) drawing attention to the untapped resources of the seabed. (Para 2.2).

While the interests of 5 out of 6 E.E.C. members favoured the creation of a Regional European Regime, a regime under which all States would benefit from the resources of to be exploited, and not just those North Sea States who benefitted from a National Sector approach, the three main benefactors of a division of the North Sea into National Sectors according to the two UNCLOS principles (1958), were Great Britain, Denmark and Norway. On this basis, these three countries between them would share in excess of 80% of the area. Since none of them were members of the Community, it was not possible for any of the disadvantaged E.E.C. countries to exercise leverage on these three by offering them trade offs in other areas of Community policy, in return to a regional approach to the exploitation of oil and gas. As a result, the creation of a Regional European Regime was not a practical possibility. (Para 2.2).

Since the Equidistance (or Adjacency) principle did not apply to the U.K. (as it was the only country on the western side of the North Sea), a straight application of the Median Line principle in a settlement with Norway would give Great Britain somewhat less than 50% of the North Sea as her Sector. While a much larger area could have been claimed by Britain if she had chosen to contest the Norwegian view that the Norwegian Trough formed part of the Continental Shelf, such a major dispute over North Sea territory would have discouraged the investment sought by Britain, and would have been contrary to the rapid development policy. To this important consideration was added the desire to deal fairly with Norway, and old friend and N.A.T.O. ally, which possessed a sound geological case for their view of the Norwegian Trough. Thus the balance of advantage to Britain lay in settling with Norway on a straightforward application of the Median Line principle, without regard to any special factors. (Para 2.2).

By settling her boundaries with Denmark and the Netherlands on the basis of the Median Line principle Britain gained an unforeseen benefit. When compensation was provided to West Germany for the poor sector she received (as a result of applying the Equidistance principle to her concave coastline) at the settlement of the North Sea Dispute, that compensation was provided at the expense of Denmark and Norway. Britain merely recognised the changes made between Denmark, West Germany and the Netherlands. (Para 2.2).

States involved in the negotiation of North Sea sector boundaries only acceded to the U.N. Convention on the Law of the Sea when it was to their advantage and according to the stage in the negotiations combined with a range of geographical and geological factors. This shows that the

negotiations were an essentially political process rather than a matter of international law. Indeed, the settlement of the North Sea Dispute (1971) referred to no principles of international law. These principles were applied only where they assisted a settlement which was acceptable to the negotiating States. (Para 2.2).

Where two or more producers access an oil and gas reservoir in common, the co-operative exploitation of that reservoir through a regime known as Unitisation, which is based upon efficient engineering principles and an agreed apportionment of costs and benefits amongst the participants, provides benefits for all, which are preferable to wasteful and uneconomic competitive production. Since the sector boundaries in the North Sea were negotiated before the distribution of oil and gas resources was known, it was appreciated at the time of the negotiations, that circumstances would probably arise where a deposit was found to straddle those boundaries, and this would give rise to the need for cross boundary Unitisation. To establish a framework within which concessionaires could co-operate to this end, cross boundary Unitisation agreements would become necessary between the countries involved. (Para 2.3).

The various North Sea countries entered with varying degrees of commitment into a series of 'agreements to agree' as and when the problem of cross boundary Unitisation arose, and the prospect of cross boundary Unitisation in the North Sea, resulted in a debate between international lawyers and others on what the proper legal and technical bases for cross boundary Unitisation ought to be. (Para 2.3).

The Ekofisk Pipeline Agreement (1973), negotiated in circumstances where Norway's interests were greater than those of Great Britain, was developed on the basis of a balanced and mutually exclusive allocation of duties between the two countries. It was feared that Unitisation, which was based upon co-operative activity would undermine the foundations of the international regime in the North Sea, which was established on the principle of national control within sectors, since a cross boundary Unitisation agreement would afford too many occasions in which one State might intervene in the sector of its neighbour, with all the prospects that held for future conflict. (Para 2.3).

The Frigg Field Agreement (1976), extended those principles already applied in the earlier Ekofisk Pipeline Agreement (1973), to a much wider series of cross boundary matters including the inherently more complex issue of cross boundary Unitisation. This Agreement, in turn, formed the basis for the management of other Median Line fields.

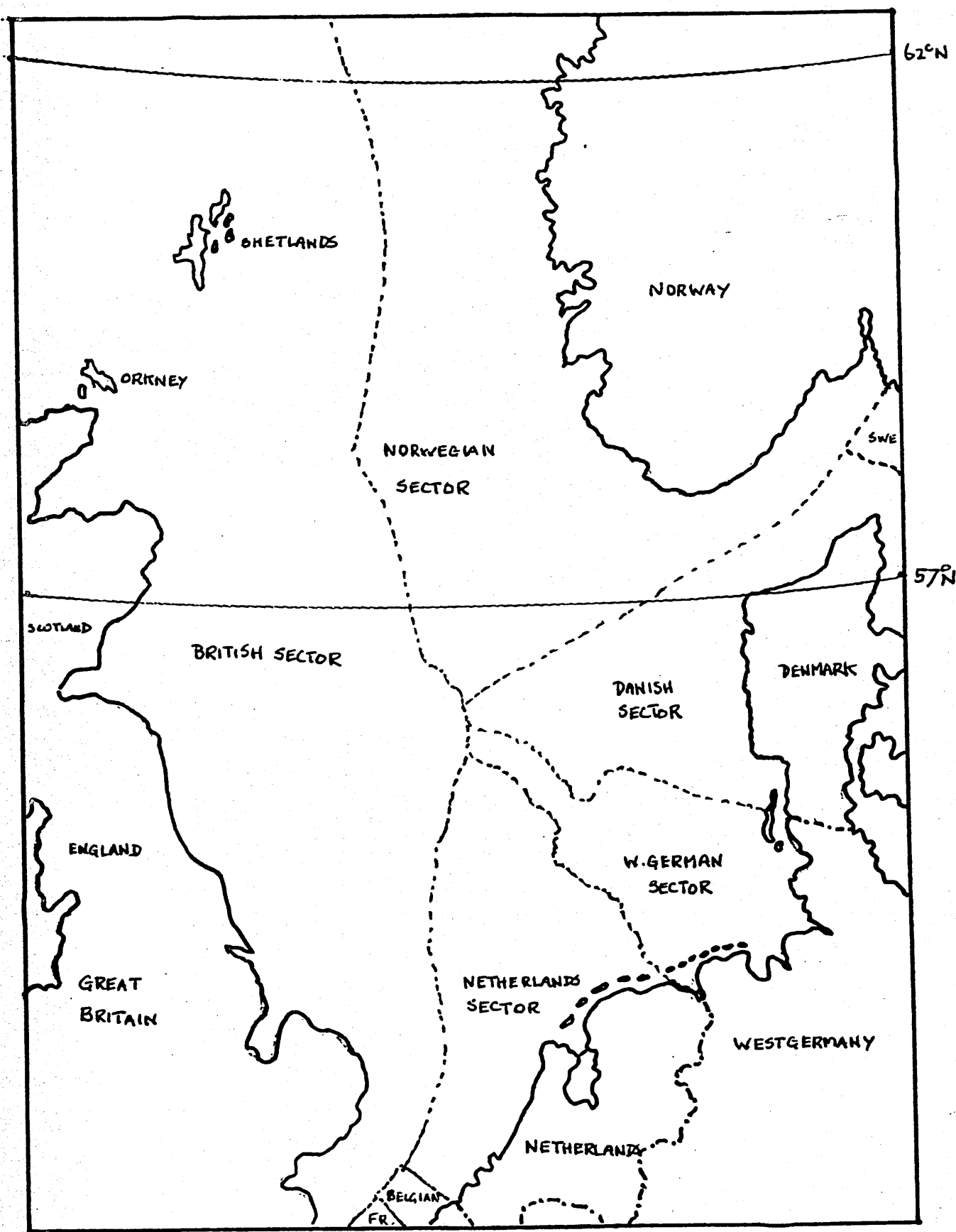
Notwithstanding some modest diminution in national authority, the principle of national control by each country within its own sector has been substantially maintained in the cross boundary agreements. There has however been a steady growth in co-operation and interdependence between Great Britain in the exploitation of the oil and gas resources of the North Sea. (Para 2.3).

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NORTH SEA SECTOR BOUNDARIES



100 Fathom Line is north of 62°N

South of 57°N depth rarely exceeds 50 fathoms

DELIMITATION TREATIES

(Excludes Treaties between Denmark, Sweden, Norway and West Germany of a minor character and irrelevant to the argument) based upon details given by C.M. Mason).

A. Treaties terminated at resolution of North Sea Dispute

	<u>Parties</u>	<u>Signed</u>	<u>In Force</u>
A1	West Germany Netherlands	Bonn 1.12.64	18. 9.65
A2	West Germany Denmark	Bonn 9. 6.65	27. 5.66

B Principal Delimitation Treaties

	<u>Parties</u>	<u>Signed</u>	<u>In Force</u>
B1	United Kingdom Norway	London 10.3.65	29. 6.65
B2	United Kingdom Netherlands	London 10.6.65	29. 6.65
B3	Norway Denmark	Oslo 8.12.65	22. 6.66
B4	United Kingdom Denmark	London 3.3.66	6. 2.67
B5	Denmark Netherlands	The Hague 31.3.66	1. 8.67

C Resolution of North Sea Dispute

	<u>Parties</u>	<u>Signed</u>	<u>In Force</u>
C1	Denmark West Germany	Copenhagen 28.1.71	7.12.72
C2	Netherlands West Germany	Copenhagen 28.1.71	7.12.72
C3	Denmark Netherlands	Copenhagen 28.1.71	7.12.72

(British Recognition of Resolution of North Sea Dispute)

C4	United Kingdom Netherlands	London 25.11.71	7.12.72
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C5	United Kingdom Denmark	London 25.11.71	7.12.72
C6	United Kingdom West Germany	London 25.11.71	7.12.72.

PART 2 DEVELOPMENT OF THE REGIMEChapter 3 The Question of Regime Change: The U.K. National Regime for Oil and Gas, 1964-1975

3.1 Introduction From 1964 to July 1974, the rapid development policy, and the conditions generally favourable to the oil industry, under which the oil companies operated in the U.K. Sector of the North Sea, remained essentially unchanged. Then, in July, 1974, ⁽¹⁾ the recently elected Labour Government announced its intention to modify these conditions in three ways. Firstly, through the creation of a national oil company to be known as the British National Oil Company (B.N.O.C.), which was to act as the agency for the introduction of a substantial measure of State participation into North Sea operations. Secondly, the system for taxing these operations was to be altered by placing a ring fence around the North Sea for the purposes of applying U.K. Corporation Tax. As a result of this change, it would no longer be possible for oil companies to offset costs and losses incurred outside the area, against tax liabilities arising from their North Sea activities. New fiscal measures (in July, 1974 unspecified, as they had yet to be consulted with the industry) would, when combined with the former decision, have the effect for the first time, of producing a substantial Government revenue from North Sea operation. Thirdly, while stating their commitment to build up U.K. Sector crude oil production in the year ahead, the Government announced their intention to take powers enabling them to control the level of such production from current and future licences. In a later Commons statement by Eric Varley, which became known as the Varley Guidelines, ⁽²⁾ they set out the (non legislative) constraints they proposed to use in the application of these controls, which had the effect of

assuring the oil companies that control over the rate of depletion from oil and gas reservoirs was a matter for the 1980's, rather than an immediate prospect. Notwithstanding the Varley Guidelines, Labour's statement of their intention to take powers for the future control of depletion rates, marked a definite break with the policy of unqualified rapid development.

Except for State participation, involving as it did the negotiation of a State interest in existing licences, and the creation of B.N.O.C. as the agency for this participation, all these measures had the broad support of the Conservative Opposition, since with the exception of the matters just mentioned, the previous Heath Government had been committed to a similar package of changes. While sharing Labour's view on the need for a greater degree of Government control over the North Sea, the Conservatives believed that this might be better achieved through their proposed conservation agency, to be known as the United Kingdom Oil Conservation Authority a body designed on North American lines. Setting aside the questions of the lower cost of the Conservative proposal, and the issue of its likely effectiveness, the real difference of approach between the two parties, arose from their contrasted ideologies on the best means for organising industry. This difference marked the first break with the hitherto bipartisan approach to North Sea policy, and thereafter, Labour and Conservative policy in this issue area was to become progressively distinct. To probe the reasons behind this divergence, the treatment of State participation and the creation of B.N.O.C., together with the subsequent development of the Corporation, through to the end of 1981, is reserved for consideration in Chapter 4.

The present Chapter will concentrate (in Para 3.2) on the reasons why conditions for North Sea operators remained unchanged from 1964 till the enactment of Labour's measures, (3,4) and further explain that particular combination of circumstances which contributed to those changes in the U.K. National Regime for Oil and Gas which took place in 1975. Outside Britain, a process of fundamental change in the world oil industry (to be explained in Para 3.11), had been in train from around 1960, and was to culminate in the world oil crisis of 1973. By 1971, this process of change had become publicly visible outside the oil industry, when the Multinational Oil Companies (MNOCs) were seen to have lost their former power to determine levels of production, and rates of investment in the principle producing countries in the Middle East and elsewhere. At Tehran in that year, (Footnote*) they were forced by a group of these countries to sign the Tehran Agreement, in which they conceded to the producing countries considerable tax and royalty benefits, together with a rise of 30¢ U.S. a barrel on the price of crude oil F.o.b. (Free on board) the Persian Gulf, plus a further 11¢ U.S. rise per barrel in each subsequent year till 1975. These concessions by the companies were made under a threat by the Governments with which they were negotiating, to cut off their crude oil supplies. After Tehran, the companies still retained a considerable technological advantage in their possession of exploration and production expertise, and remained the dominant factor in worldwide transportation, refining and distribution

Footnote *

Actually, there were two linked agreements, The Tehran Agreement (14/2/71) in respect of the Gulf States; and the Tripoli Agreement (20.3.71) in respect of Mediterranean Producers. Negotiations on the company side were co-ordinated by the London Policy Group (LPG).

activities. However, in order to protect the supplies of crude oil they required to carry on this range of integrated activities, they became more or less willing partners in participation agreements, with the host Governments in the producing countries. Under these participation agreements, State participation within the producing countries, was progressively extended on organised and reasonably effective basis, in a process which a Kuwaiti Oil and Finance Minister frankly observed, was in reality a form of creeping nationalisation.

Viewed from Britain, this process of change within the international oil industry, suggested to both Conservative and Labour politicians (well before the events of the 1973 oil crisis provided them with a powerful case for the extension of Government control over North Sea activities), that the time might well be right for U.K. to obtain an improved financial return from the North Sea. From 1969 onwards, interest had switched from the southern gas fields supplying gas to meet the needs of the U.K.'s nationalised gas industry, to newly discovered oil fields further north. A number of important oil fields had been discovered in the north of the British Sector in the years between 1969 and 1971: Montrose (September 1969); Forties (November 1970); Auk (February 1971); Brent (July 1971); Argyll (October 1971). These finds reinforced the view in both the Conservative and Labour Parties, that given these new resources, the time was obviously right for the Government to secure improved terms from the oil industry for their exploitation. This bipartisan opinion, which arose in some measure from a sense of Britain's relative deprivation, compared with the 'take' of other oil industry host governments, gave far too little weight to the considerable

time which must elapse between the discovery of such oil fields, and their development to full production. Neither was there a proper appreciation of the costs involved in this process.

It was in these circumstances, that criticisms of the existing U.K. National Regime for Oil and Gas crystallised in the Findings of the Public Accounts Committee, 1972/1973.⁽⁵⁾ These Findings, prepared before the 1973 oil crisis will be analysed, so as to relate them both to changes within the international oil industry and progress in the exploitation of the northern North Sea oil fields. In this context it will be explained how the U.K. National Regime for Oil and Gas remained essentially unchanged for a decade, and why when changes came, they particularly occurred in 1975, and not at some earlier date.

As an aid to the argument, the broad shape of the Committee's Findings must first be outlined. At the core of these Findings was the Committee's concern over the failure of the arrangements in force to produce any substantial revenue for the British Government. The failure of the fiscal system to produce any significant tax revenue up to 1973 was noted, and the Government was criticised for permitting this situation to persist, particularly in the absence of any compensating factor in the shape of State participation in the exploitation of the northern North Sea oil fields. The situation which allowed costs and losses outside the North Sea to be set against tax liability for U.K. Corporation tax arising from North Sea operations should be ended.

As regards Licensing Policy, far too much territory had been allocated too quickly for overlong periods of time - 46 years without any provision for renegotiation of terms. An experiment in bidding for licences, which had shown the considerable revenue which might accrue from such an approach had been included in the 4th (then the latest) Licensing Round, but should have preceeded it. Even when the results of this experiment were known, there was still time to cancel the 4th Licensing Round. Yet no action was taken to put this option before Ministers. In the view of the Committee, there ought to have been a full Ministerial Review of Licensing policy before the 4th Licensing Round. While the rapid development policy was noted, the Committee made no call for the introduction of depletion controls.

As regards the exploitation of southern North Sea gas, the Public Accounts Committee recognised that the faults of the fiscal and licensing system in failing to produce revenue, were substantially mitigated by the involvement of the Gas Council, both as a North Sea Operator, but more especially since the Council was the only, or monopsony buyer of gas from the operating companies, unless the gas was to be used for non fuel purposes, i.e. chemical feedstock. Thus there was no criticism of the arrangements for the management of southern North Sea gas, under which the nationalised gas industry obtained its supplies of natural gas at prices well below international market levels.

In a further criticism of Government policy, the Public Accounts Committee drew attention to the lack of effective measures to stimulate the development of a home based offshore supplies industry prior to the

commissioning of the IMEG Consultants Report (6) which was published in May 1972.

The various critical findings of the Public Accounts Committee (those relating to Government revenue and the fiscal system, licensing policy, and the offshore supplies industry) will be considered against the background of the rapid development policy, changes in the international oil industry, and Stages 3 and 4 of the model derived from Hossain. Stages 3 and 4 of this model demonstrate that the further oil companies become engaged in the task of developing oil and gas reservoirs, in order to bring them to full production, the more costly it becomes for them to disengage from the enterprise. At the same time, the companies become more vulnerable to host Government action, designed to increase the host country's 'take' and progressively introduce State participation. The point of maximum vulnerability for the companies is reached with the achievement of full production. On the basis of these considerations, it will be explained why British Government action to change the character of the U.K. National Regime for Oil and Gas did not follow immediately from the publication of the Public Accounts Committee's Findings, but took place particularly in the year 1975.

The failure of Government action to stimulate the growth of a home based offshore supplies industry prior to the commissioning of the IMEG Consultants Report will be further related to a substantial consensus within the two Parties between 1964 and 1975 on the value of foreign investment, allied for most of the period to an uncritical view of foreign based multinationals, which tended to depoliticise the issue of their impact upon the domestic

economy. A further factor will be shown to have been the development of Conservative industrial policy between 1970 and 1974, which passed through two phases. The earlier phase of general industrial disengagement and no help to 'lame ducks' was not conducive to Government action to stimulate the establishment of a home based offshore supplies industry. However, the need to nationalise Rolls Royce and Upper Clyde Shipbuilders initiated a second and more interventionist phase, the commencement of which fitted well with the recognition that a more positive Government approach to stimulating a home based offshore supplies industry was desirable. The measures taken by the Conservative Government will be set against the background of this more interventionist phase in their policy. The role of the Offshore Supplies Office will be described. This agency monitored progress and performance by U.K. firms, helped to clear blockages to progress (e.g. with planning applications) and audited the Quarterly Returns on offshore supplies, which the Government required the companies to submit, using the leverage derived from the discretionary allocation of licenses under the Administrative Allocation Licensing System, to secure effective compliance. The role of Interest Relief Grants to place British contractors on an equal footing with foreign firms subsidised by their own Governments will be explained.

On this basis, it will be shown how the 1974-1979 Labour Government, committed to a more interventionist industrial policy than the Conservatives, built up the role of the Offshore Supplies Office, by introducing the 1975 Memorandum of Understanding which required the oil companies agreement to the principle of 'full and fair opportunity' for British firms. It will be shown that the association with the Department of Energy gave the Offshore

Supplies Office considerable influence, since the DOE had control over both licensing and the approval of development schemes. Thus the oil companies were forced to comply progressively with what was in reality a 'Buy British' policy, a policy which in later years meant they were to buy 70% of offshore supplies from U.K. sources. This was an arrangement with which in all fairness, the companies frequently stated themselves to be well satisfied.

Labour's decision to take powers for depletion control (subject to the constraints of the Varley Guidelines) will be considered against the background of the following factors. Firstly, there were expectations of further increases in crude oil prices, which would make it more profitable to leave crude oil in the ground so as to escalate in value, rather than to extract it for use at current prices. The likely increase in the crude oil reserves of the British Sector tended to reinforce this argument. A second consideration was the value of these crude oil reserves as a hedge against another energy crisis, while a further factor was the growth of informed concern at the consequences of an exhaustion of all mineral and natural resources, arising from influential work of the Club of Rome.

There remains however, the need to consider (in Para 3.3) those arrangements established in 1964 for the exploitation of the southern North Sea gas fields, arrangements which were not criticised by the Public Accounts Committee or changed in any significant fashion by either the Heath Government or their Labour successors. In this connection it must be recalled that when the foundations of the 1964 regime were laid in the Continental Shelf Act, they took particular account of the need to manage

such gas deposits, which it was confidently expected would be found in the southern part of the British Sector, and which were indeed discovered there between 1965 and 1969. The cost benefit analysis made for converting the gas supply industry to natural gas will be set out, since the assumptions behind this analysis, included a very favourable price to be paid for gas delivered to the gas industry by the producing companies. In this context it becomes clear why the Gas Council was made the sole (monopsony) purchaser of such natural gas, except where it was to be used for non fuel purposes, i.e. as chemical feedstock.

The system of pricing developed under conditions where the Gas industry was the sole purchaser involved negotiations unlike those in any real market. It will be shown that these had the effect of dividing the economic rent, which is the difference between the true market price of a product, and that price which is just sufficient to keep the producer in business, between the gas industry and the oil companies in a manner highly favourable to the former. To compensate the companies for a price well beneath international market price for their product, they were permitted to deplete the southern North Sea gas deposits at rates somewhat in excess of those actually required by the gas industry. Thus the companies obtained by turnover what they could not obtain through a higher unit price per therm. The prices paid the oil companies remained well below international market prices, despite subsequent renegotiations of the original contracts designed to take account of altered economic conditions, principally the effects of increased rates of inflation, competitive bidding for Norwegian gas, and changes in world gas prices.

Against this background, the process of price negotiations between the gas industry, represented by Sir Dennis Rooke, and the oil companies, will be investigated, showing how the constraints of bargaining within the monopsony system, given the limited possibilities for use of the gas as chemical feedstock and the Government's refusal of permission to sell the gas in alternative markets, had the effect of shifting the balance of advantage in the Oil Company-Government relationship to the government side, so that the Gas Council secured their desired outcome. Arising from the prices they received under these arrangements, the oil companies claimed that their return from the southern gas fields was insufficient to fund the further exploration and development needed to find and exploit the smaller gas fields needed to secure longer term supplies. The evidence for and against this claim will be considered.

3.11 Regime Change in the World Oil Industry Events in the international oil industry outside Great Britain had an impact on the changes in the U.K. National Regime for Oil and Gas introduced in 1975. In order to assess this influence, the process of regime change within the international oil industry from 1946 onwards must be appreciated. The nature of the regime which existed from 1946 under the aegis of the seven Multinational Oil Companies (MNOCs) will be established, followed by two phases by which this regime was modified prior to the fundamental changes initiated by the 1973 oil crisis.

The period from 1946 to 1960, was characterised by a globally integrated world oil industry built around the activities of seven Multinational Oil Companies (MNOCs), known as the Majors: BP, Royal Dutch/Shell, and 5 U.S. companies, Esso (now Exxon), Mobil, Gulf, Socal and Texaco. To these was

added the French company CFP, a junior Club member with a strapontin position. The origins of this regime lay in arrangements made between the Wars, principally an accommodation between British, Dutch, French and U.S. interests over access to the oil resources of the former Ottoman Empire (The Red Line Agreement 1928), and the Acnachary Agreement, between BP, Esso and Shell, known as the 'As is' agreement because it froze market shares and eliminated competition amongst the partners. Such arrangements (not uncommon between large international companies at the time) formed the basis for an ongoing loose alliance, ⁽⁷⁾ elements of which remain today (e.g. Shell/Esso in the North Sea.) The 8 companies involved were horizontally integrated in so far as their activities extended to most of the countries of the non Communist World, and vertically integrated in that their activities included both Upstream operations (exploration and production) and Downstream operations (transportation, refining, distribution and marketing of products). The Upstream operations were carried out in the principal producing countries under favourable concession terms which enabled the companies to determine the rates of investment in the industry and the level of production, and thus to regulate any imbalance between local production and the requirements of their worldwide Downstream operations. Waste was thus eliminated. The relative market shares of each Major were maintained. Crude oil prices were determined in a market which was substantially dominated by the activities of these Major oil companies.

As the years passed, the Middle East became the most important producing area in the world, and since the costs of producing crude oil in countries such as Saudi Arabia were so much lower than elsewhere, relatively cheap

crude oil in substantial quantities was readily supplied to the western economies, which as a consequence became progressively oil based, as cheaper oil products displaced higher cost home produced fuels, which were either coal or gas produced from coal.

Throughout these same years, British power declined with the close of the Colonial era, the vacuum so created being filled by the United States, as leader of the Western Alliance. Concurrently with this change, a rising tide of nationalism was taking place in those countries so long dominated by the West. Nowhere was this more true than in the countries of the Middle East. Two events, the Iranian Crisis (1952/1953) and the Suez Crisis (1956) were landmarks in this process of change, and stages which already marked the decline of British power and its replacement by that of the United States. Both of these events also resulted in oil supply problems for the western countries, which demonstrated that the survival of the regime and the security of the West against an oil embargo, rested upon the availability of alternative crude oil supplies from politically stable producing areas. The United States herself was one of these alternative sources of supply, and a net exporter of crude oil, so that it was difficult to exert leverage upon her by a withdrawal of oil supplies. These factors enabled the United States, operating through the regime at times of crisis, to organise the supply of crude oil to her allies, thus increasing their dependence upon her leadership. However, the regime also persisted for another very important reason. This reason was the interdependence of the interests of the oil consuming and oil producing countries, since the former required a continuing supply of crude oil to fuel their economies, while the latter required a continuing flow of revenue to fund their development plans. These two

interdependent factors contributed jointly to the progressive integration of the world economy, which formed so important a stimulus for its continued growth. (8) (Footnote*)

Notwithstanding this basic interdependence of interests between the consuming and producing countries, as it existed in the years from 1946 onwards, many of the producing countries felt a sense of grievance. The concessions under which the Majors operated had been negotiated in the Colonial era, as between unequal partners. Large territories had been covered by these concessions, and at the time when the concession agreements had been signed, the vast resources available for exploitation had not been appreciated by either side to the bargain. In the event, it often proved impossible for the concessionaires to adequately exploit all the territory involved, yet in many instances, the provisions for relinquishment of territory in the event of non exploitation were defective. This naturally served the interests of the concessionaires, since the territory could not be transferred to competitors, whose entry into the business would have been a threat to the Cartel of Majors.

Footnote * The increased price which the West had to pay for crude oil from 1973 onwards, and more especially the temporary price escalations of 1979, following the fall of the Shah, and 1980, on the outbreak of the Iraq Iran War, may be viewed as having so disrupted this relationship as to have contributed significantly to the world depression of the early 1980's, with which has been associated a general reduction in energy demand, that has so adversely effected the economies of the oil producing nations.

The Iranian Crisis had demonstrated to the other producing countries, that as a means of improving a producing country's position, the strategy of outright nationalisation, as employed by Mossadegh, was inappropriate, in view of the unacceptable penalties it brought. Iran's crude oil had been excluded from the international market and the Downstream infrastructure of the Majors pending a settlement. The resolution of the Iranian Crisis in 1953/1954 had begun with the displacement of Mossadegh by General Zahedi, and the return of the Shah, an operation in which the C.I.A. was involved. When the final settlement was concluded, the purely British interest which had been represented by the Anglo Iranian Oil Co. Ltd., was replaced by a Consortium of British, Dutch, French and U.S. interests, in an agreement negotiated on the Iranian side by the remarkable diplomat Abdullah Entezam. The disruption which had been caused by outright nationalisation, was clearly unacceptable.

During this period however, there was one development, which suggested an alternative strategy for producing countries seeking to improve the benefits they obtained through the oil industry. It involved a modest break with the control exercised by the Cartel of Majors, through what were called 50-50 Agreements or Joint Ventures. The origins of this development were as follows. In the 1950's the U.S. Government became worried about the decline in domestic U.S. oil reserves. Within the U.S.A., there existed some very important oil companies, who though their operations were purely domestic, possessed the necessary exploration and production expertise to engage in foreign operations, although their financial resources were not so extensive as those at the command of the Majors. These companies, who were collectively known as the Independents, which term marked their independence

from the Majors, were offered a tax concession called a depletion allowance, conditional upon their seeking new oil resources abroad. These Independents, together with the National Oil Companies (NOCs) of the consuming countries, most notably the Italian State company E.N.I., negotiated a series of new agreements with the producing countries, on those relatively small areas of new or relinquished territory which were available. This they did, on terms more favourable to the host Governments than those of the original concession agreements. Investment costs, taxes, royalties and profits were split equally between the host country's National Oil Company (NOC) and the foreign company in the event of success, but in the event of failure, the foreign company took the whole risk. The use of the terms 50-50 Agreement or Joint Venture to describe these arrangements, stressed the concept of partnership, which was to become so important in the years ahead.

These new arrangements were to trigger further developments, which would prove to be of growing significance in the future, since they brought on to the market a relatively small amount of crude oil free from the control of the Majors. At the same time, a number of refineries were being built in the oil consuming countries, similarly free from the control of the Majors, with a view to providing a measure of supply flexibility in the event of an oil embargo, and further assisting these countries with their balance of payments. Thus in a small way, complementary facilities were being developed on both the supply and demand sides of the oil industry, which were free from the control of the Majors.

As Fadhil at Chalabi ⁽⁹⁾ and Walter J. Levy ⁽¹⁰⁾ stress, 1960 was a

watershed year, which initiated a period of steady and ongoing change within the international oil industry, through to 1968. The introduction of fresh crude oil into the market as a result of the Independents' foreign operations, had the effect of adding a degree of uncertainty to the Majors' market calculations, the impact of which was not dissimilar from the effect of Soviet crude oil sales, which were made either for political reasons, or according to commercial criteria quite unlike those which normally obtained in the Free World. The Independents, lacked the financial resources of the Majors, so that when they were faced with market surpluses, which coincided with their own serious cash flow problems, they tended to react by cutting their prices excessively. The Majors, anxious to restore their competitiveness, cut their crude oil prices in turn, which had the effect of seriously alarming the producing countries, concerned over the security of their development funds.

By 1960, these price cuts were beginning to have a serious impact on the various oil producing countries, so that when Aramco (the Arabian American Oil Co, which was owned jointly by Standard New Jersey, Standard of California, The Texas Co, each with 30%, and Socony with 10%) cut the price of Saudi crude oil by 9 U.S. ¢ a barrel, an alliance was formed between Abdullah Tariki of Saudi Arabia and Perez Alfonzo of Venezuela, which led to the formation in September 1960 of OPEC (The Organisation of Petroleum Exporting Countries). The new organisation had an initial membership consisting of the 5 dominant oil producing countries Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. The formation of OPEC, with the initial aim of restoring the price cuts which had triggered its birth, was a collective political statement by the membership, that they were no longer willing to

leave the determination of crude oil prices, upon which so much of their future rested, exclusively in foreign hands. An agreement was reached between OPEC and the companies, in which it was agreed that the real value of crude oil would be restored over a period of five years, so as not to unnecessarily disturb the market. The producing countries within OPEC then took on the role of junior sleeping partners in the process of price determination, and began to use their collective strength to bring about changes in the system, which would be to their advantage. It was not at this point their intention to radically change the arrangements under which the international oil industry was managed. Over the years the membership of OPEC was extended as follows: Qatar (1961); Indonesia (1962); Abu Dhabi (1967); Algeria (1969); Nigeria (1971); Ecuador (1975); Gabon (1975).

From the early 1960's the U.S.A. became a net importer of crude oil, and over the decade as a whole, she moved to a point where some 15-20% of her crude oil needs had to be imported. As a result, while formerly sensitive to the effects of an oil embargo through the need to assist her allies with crude oil supplies, she now became vulnerable herself to the impact of such an interruption in supplies, and less able to lead the Western countries in withstanding such a threat. The crude oil available to the Western countries from other than Middle East sources was no longer sufficient to withstand a prolonged embargo from that area. In 1967, as a response to the Arab Israeli War, Algeria nationalised 51% of French oil interests in that country, imposing participation on the French, and by this means securing a market outlet for the resultant crude oil. In 1968, OPEC included the objective of securing participation in its Statutes. From being a buyers market for crude

oil at the start of the 1960's, conditions had now changed so that it was a sellers market. The OPEC objective was now to extend State control over Upstream (exploration and production) activities, while retaining foreign expertise, since the oil companies dare not withdraw from the enterprise for fear of losing their crude oil supplies. While the Majors remained dominant in crude oil transportation and trading, even in this phase of the business the role of the National Oil Companies (NOCs) was growing, and the consequences which arose from all these changes will be explained at the start of Chapter 4.

In 1969, a second and more accelerated phase of change began, triggered by events in Libya. In that country, some 20 foreign oil companies were operating, including the Majors. However, these various companies did not operate as a Consortium, and their interests were not all identical. For some of these companies, Libya was their only source of crude oil, which made them vulnerable to any action by the Libyan authorities. The new Libyan Revolutionary Government imposed crude oil production cuts, and then defeated the oil companies in detail, since their varying interests meant that they lacked the strength to maintain a common front. Before long, one of the oil companies operating in Libya, Occidental Petroleum, surrendered to Libyan Government pressure and conceded the Libyans improved terms, and it was not long before Libya obtained from all the companies a combination of improved tax payments, a 30 ¢ U.S. a barrel price increase and a 2 ¢ U.S. a barrel price rise in each successive year till 1975.

It was these events in Libya which demonstrated the vulnerability of the oil companies to the other producing countries, and led ultimately to OPEC's

imposition of improved terms upon the companies in the Tehran Agreement (1971), under a threat of withdrawal of crude oil supplies. As an outcome of Tehran, crude oil prices rose by roughly 15%, the companies gave up the special discounts that they had enjoyed on certain crude oils, and the grading of crude oils for pricing purposes was revised. At two further conferences at Geneva, the companies guaranteed the OPEC producing countries against the impact of currency changes on their revenue. Two supplementary agreements were reached at Lagos and Tripoli, dealing with regional issues. It was clear from Tehran, that in future the OPEC countries intended to take a far more aggressive role in respect of price determination. It was Tehran that brought about a growing awareness in Britain of the changes which were taking place in the international oil industry, which coinciding with an appreciation of the oil resources available for exploitation in the northern part of the British Sector of the North Sea, together contributed to demands for change in the U.K. National Regime for Oil and Gas.

In Autumn 1973, as a consequence of the Yom Kippur War, the Arabs embargoed supplies to two of the Majors' home countries, the U.S. and the Netherlands, ostensibly for their assistance to Israel. Whatever the support provided to Israel by the U.S., the embargoing of supplies to the Netherlands arose more from an appreciation of its wider impact, since Rotterdam was an important centre of the oil trade. The effect of this embargo, could not as a result be localised. Supplies of crude oil became very tight, and as a result, the price of Saudi Arabian Light crude oil rose from U.S.\$ 2.89 in June 1973 to U.S.\$ 5.12 in October 1973, to U.S.\$ 11.65 by Christmas, while on the spot market (i.e. the free market) the price reached U.S.\$ 22.5 at about the same time. It was in these circumstances that BP and Shell refused

to give preferential supplies to the U.K., unless the British Government issued them with an instruction to this effect, stating clearly against which other countries they were to discriminate. It was these events (discussed fully in Chapter 4) which convinced Edward Heath of the need for Britain to exert greater control over her own North Sea crude oil.

In November, 1974, the oil consuming countries of the O.E.C.D. formed the International Energy Agency (the I.E.A.), to carry out research on energy conservation and the use of alternative energy sources, to build up relationships with the oil producing countries, and to create emergency procedures and stocks. The plan for creating emergency procedures and stocks, was known as the International Energy Programme (I.E.P.). The oil companies became involved in the process of developing and implementing these procedures, including the building up of the necessary stocks, since by this means they safeguarded themselves against the possibility of being asked to discriminate for or against particular countries in any future oil embargo, while the United States pledged itself to make its oil available to assist its allies in the event of another curtailment of supplies, since by this means Henry Kissinger, who expected the U.S. to become energy self sufficient by the 1980's as a result of Nixon's Project Independence, hoped to reassert U.S. leadership of the Alliance. (Footnote*)

The Western oil companies, in order to safeguard their crude oil supplies, entered into partnership with the producing countries, in projects to build Downstream facilities such as chemical plants and refineries in those countries, notwithstanding the surplus refinery capacity in the Western

consuming nations, itself a consequence of the early stages of recession, which is some respect derived from higher crude oil prices. Since in the final resort, the key resource of the companies is their technology, a more recent development has been the Service Agreement, in which work is carried out by an oil company for a country for a fee, without any share in the equity. (Footnote **)

Footnote* Krapels (11) explains that a programme such as the I.E.P. if it is to be successful relies on a combination of two elements, effective national stocks and a programme for their fair allocation. A 10% reduction of supplies effects Japan which bases 70% of its energy economy on imported crude oil to a greater extent than the U.S. which has only 50% of its needs met by crude oil, and has domestic supplies. This is the basis for allocation, namely the differing needs of members. The effectiveness of national stocks (usually 90 days) is constrained by the costs of holding stocks. After a certain delay, the I.E.P. is triggered when certain levels of supply constraint, either globally or with respect to a single member, are reached. Fortunately, Britain is one of the four major industrial nations (Canada, U.K., USA and U.S.S.R. which have domestic supplies available. Countries usually pursue the often mutually opposed objectives of an ongoing supply of crude oil and a stable price. The automatic triggers of the I.E.P. can only be stopped by a weighted vote of the members. One of the objects of the I.E.P was to prevent the 'beggar thy neighbour' policies where consuming countries sought Government to Government deals at the time of 1973 oil crisis. Paradoxically though, the system being designed to assist countries, it proved unable to assist the main sufferers from the 1979/80 oil rises, Majors such as BP, and Independent refiners, such as those in Japan. (12)

Footnote ** For the detailed study of regime change up to and including 1973, an essential source is: U.S. Senate, Sub-Committee on Multinational Corporations, Committee on Foreign Relations. Hearings (1974/1975) 12v. (Known as the Church report after Senator Frank Church).

3.2. Regime Change in the U.K. National Regime for Oil and Gas Having established the framework of the wider changes in the international oil industry, which had an impact on the formation of opinion in the U.K. about the need for change in the U.K. National Regime for Oil and Gas, the focus of attention can be turned to events in Britain itself, and more particularly the state of development of the northern North Sea oilfields, which was an important factor in the Government's timing of the changes which occurred in 1975.

A full list of the commercial oilfields discovered between 1969 and 1971 was given earlier, and it will be recalled that the first of these commercially viable oilfields was the Montrose Field discovered in September 1969, in the same year that the Libyans secured those greatly improved terms from the 20 oil companies operating in Libya, which event was instrumental in triggering a phase of accelerated change in the international oil industry, which culminated in the events of 1973/1974. Neither the first significant oil discoveries in the northern North Sea, nor the importance of the Libyan success were widely appreciated when they first occurred.

With respect to the oil discoveries, this resulted from two factors. Firstly, it was the result of the delay which took place between the announcement of a discovery and the taking of a development decision. For

example, in the case of the very important Forties Field, the discovery was announced in August 1970, but the development decision was only taken in December 1971, after Sir Eric Drake, the Chairman of BP had received assurances from John Davies the Secretary of State for Trade and Industry (into which the Conservatives had merged the Ministry of Power), that no modification of the terms under which BP was operating would take place while the development of the Forties Field was underway. Sir Eric was concerned over estimates for the cost of the task, which were £100 million, and which in practice proved to be £1,000 million. The second factor which delayed public awareness of progress in the northern North Sea, was the reticence of many of the Operating Companies about publicising their success, for unlike BP, they felt that such publicity might give some advantage to their competitors. As a consequence, it was probably the Tehran Agreement (1971) which by demonstrating the weakened position of the Majors, focussed public attention on the possible value of Britain's own North Sea oil.

There were some exceptions to the general lack of an appreciation of the significance of events in Libya. The companies of course, because they were involved in these events and their consequences, had a very good appreciation of their significance, but hoped that the final nationalisation of their assets through the process of participation, might yet be delayed for many years. A very similar appreciation of the Libyan success, was held by Angus Beckett of the Department of Trade and Industry's Petroleum Division. Like the companies, Beckett foresaw that the Libyan achievement must ultimately lead to full nationalisation in many of the producing countries, though like them, he also believed that this eventuality lay some time in the future. Operating on this scenario, (13) he advised that the 4th Licensing Round

should continue the generally soft terms which had applied formerly, with a view to stimulating exploration activity, which had fallen off. Taking Account of the Tehran negotiations then in progress, he feared that the announcement of stiffer terms by Britain in the North Sea, would provide the overseas producing countries with just the excuse they needed in order to move rapidly to full nationalisation, at a time when most British companies overseas were operating under less disadvantageous participation agreements. To discover the true value of Britain's oil, while not providing such an excuse for a rapid move to full nationalisation overseas, Angus Beckett advised that an Auction Bidding experiment, covering territories of varying likely worth, be included in the 4th Licensing Round. It is perhaps ironic, that the Public Accounts Committee, one of whose objectives was also to assess the true value of Britain's oil, were to criticise the timing of this experiment, and its inclusion in the 4th Licensing Round. As will be shown later, however, they were also concerned to enquire why the Government had so far failed to take measures to improve its income from the North Sea, which compared so unfavourably with that obtained by overseas producing countries. In this context, they did not give the same weight as Beckett to the likelihood of retaliatory action by the OPEC countries against British oil companies being triggered by British action to improve the Government's financial return from the North Sea. Beckett resigned before the publication of the Public Accounts Committee Findings, which were so critical of decisions taken on the basis of his advice.

Following the Tehran Agreement (1971), belief grew both within the Conservative and Labour Parties that Britain should obtain improved financial benefits from her North Sea oil, comparable with those obtained by overseas

producing countries. Tom Balogh, economic advisor to the previous Wilson Government (whose role in the development of B.N.O.C. will be described in Chapter 4) lobbied his Labour Party colleagues to have the issue of Licensing policy for North Sea oil placed upon the agenda of the Public Accounts Committee. In February 1972, he made his views public in a Sunday Times article ⁽¹⁴⁾ in which he stated that unless Britain stiffened her terms she would continue to receive a poor financial return from the North Sea relative to the revenues received elsewhere. Balogh described the companies' use of transfer pricing, by which means artificially created book losses overseas were combined with the operation of double taxation relief so as to enable them to escape from the payment of U.K. Corporation Tax. Balogh's advocacy of regime change, so as to improve the economic and financial benefits Britain would obtain from North Sea oil, was such that by the opening of the 1972/1973 Session of the Public Accounts Committee, both Conservative and Labour members had a broad idea of what they thought Britain ought to be receiving from North Sea oil, and were jointly determined to probe the financial weaknesses of the regime, and thereby to press the Chancellor of the Exchequer for the early implementation of the changes they believed necessary.

More or less concurrently with the 1972/1973 Session of the Public Accounts Committee, support was growing for the Scottish National Party. The SNP were making projections at various levels of crude oil prices, of the benefits accruing to the economy of an independent Scotland. On this basis they were able to present to the Scottish electorate a choice between a rich independent Scotland and continued membership of a relatively poor Great Britain.

The Public Accounts Committee opened its 1972/1973 Session on 15th May 1972 under the Chairmanship of Harold Lever, though when he fell ill, the Chair was taken over by Edmund Dell. As a result of the climate of opinion in Parliament brought about by a combination of changes in the international oil industry, and Tom Balogh's advocacy of changes in the U.K. National Regime for Oil and Gas, the Committee considered critically three matters which were obviously connected with the economic and financial benefits they felt Britain ought to receive from North Sea oil.

These were taxation, Licensing policy, and the failure to take measures till a quite recent date, with a view to stimulating the development of a home based offshore supplies industry. The Committee also considered depletion policy, but accepted the absence of any such policy, in view of the continued primacy of the rapid development strategy. In examining the regime for southern North Sea gas (for the exploitation of which the 1964 arrangements had been primarily established) the Public Accounts Committee took the view that since under this system, the Gas Council was involved both as the monopsony buyer of gas from the companies, and as a southern North Sea operator, the strictures made about the poor financial return from northern North Sea oil, were largely mitigated in the case of gas. Neither the Conservatives before 1974, nor the Labour Government thereafter, contemplated any changes in these arrangements, though the companies claimed that their return from the monopsony pricing system was so poor that it was insufficient to find and exploit the smaller gasfields, whose resources would be needed, once production from the larger deposits began to decline. For these reasons, consideration of the gas regime will be reserved for Paragraph 3.3, where the basis of the regime will be fully explained and the companies'

claim evaluated.

The Public Accounts Committee's views on taxation, licensing policy, the failure to stimulate an offshore supplies industry and depletion policy will now be considered to establish in each case, those factors which were important in determining the timing of change. The Committee's criticism of taxation and licensing policy will be considered first in Paragraph 3.21, and set against the background of those considerations which led both the Conservative Government and its Labour successor to move towards the introduction of changes in 1975, and not at an earlier date as a result of those particular structures.

3.21 Taxation and Licensing Policy and the Timing of Change As regards taxation of North Sea oil operations, the Public Accounts Committee found that most of the work done in the North Sea was done by oil companies, who held over half of all North Sea Licenses. The principal share of the work done in the North Sea by oil companies, was in the hands of nine international oil companies. Due to the operation of Double Taxation Relief, the liability of these companies for U.K. Corporation Tax was largely extinguished by credits for tax paid elsewhere. Tax not paid by these nine international oil companies as a result of various forms of exemption had reached £1,500 million, and this figure would continue to grow if no action were taken, since there was no time limit on how far forward such unpaid taxes could be carried against future liabilities. By contrast, the Government's total revenue up to that date from all licence fees and royalties was only £66 million. (15)

Plasschaert (16) explains that horizontally integrated companies move monies and commodities between different countries, to secure commercial advantages. Vertically integrated companies, have prices called transfer prices, at which to transfer products in various stages of manufacture, between subsidiary companies carrying out successive phases in their vertically integrated operations. The Majors, were both vertically and horizontally integrated companies, and the Committee noted that the prices at which their overseas producing companies transferred crude oil to their trading organisations, were so low that these producing companies made losses, and these losses were then set against liability for U.K. Corporation Tax. Such experience suggests a high degree of central planning and coordination, together with a willingness by overseas profit centres to accept such losses. It is doubtful, even if otherwise possible, if such a policy could be sustained in present day conditions, due to the high degree of dissatisfaction this would cause to those parts of a Group forced to carry a loss.

The Public Accounts Committee found that where a company in the North Sea was part of a wider Group, then expenditures in no way directly related to North Sea operations could be allocated to North Sea capital allowances, and thus set against tax liabilities arising within the area. A Group's tanker company, for example, could build a tanker for use outside the North Sea, yet the tax regime allowed this expenditure to be set against North Sea tax. Without a change in the existing tax arrangements, the Treasury could not expect to receive any revenue, even in 1980, the then expected year for the achievement of oil self sufficiency by the U.K. While North Sea Operators were expected to provide the Government with geological

information, they were under no obligation to provide the Government with financial information relating to their costs, and where this was provided on a voluntary basis, its inadequacy was repeatedly demonstrated by the inability of witnesses before the Public Accounts Committee, to provide adequate answers to the Committee's questions on financial matters. True tax liability could not be assessed without proper cost data. As a result of these factors, the Committee concluded, there was no way in which Britain could hope to secure either the 'take' or the benefit to its balance of payments, which other countries had obtained by having oil produced within their territories.

As regards licensing policy, the Committee took the view that too great a weight had been given to the possibility of repercussions from OPEC countries, when formulating the soft terms of the 4th Licensing Round. It will be recalled that the terms of this Licensing Round had been built upon the advice given by Angus Beckett. The Second and Third Round terms had been formulated with the expectation of gas discoveries in the southern North Sea, where the involvement of the nationalised gas industry provided a proper return to the country in the view of the Committee, but the 4th Round of June 1971, was a very different matter, since oil deposits were concerned, and the enterprise was entirely in the hands of private interests. The Committee believed there should have been a full interdepartmental review of policy, in these changed circumstances, before the terms, timing and scale of the 4th Round were decided. If the object of the tender (auction bidding) experiment had been to learn lessons on the use of this method, then it should have taken place at an earlier date, so that its results could have been assessed, and the experience so gained, incorporated in the licensing of further

territory.

The total return from the tender experiment had been £37 million, including a single bid of £21 million from Shell/Esso, which suggested that although it was not possible to scale up these results for the whole territory allocated in the 4th Licensing Round, a very considerable revenue might have been obtained, by extending the tender approach to that very large amount of territory, which had now been irrevocably allocated with no provision for State participation. The Committee were not convinced that the revenue advantages of the tender approach, could not be combined with the safeguards associated with Administrative Allocation. They did not mention the advantage of Administrative Allocation, that it provided the Government the possibility of discriminating for or against particular applicants. The Committee pointed out that when the results of the tender experiment were known on 21st August, 1971, there was still time to cancel the rest of the Round, but no interdepartmental meeting took place to consider this possibility, and the matter was therefore never put to Ministers for a policy decision. It was considered highly unsatisfactory, that all the most promising areas in the North Sea, were now allocated on terms essentially unchanged from those of 1964, and that the rights to the territory were assigned for 46 years, with no break clause, or means to renegotiate the terms with a view to including a measure of State participation.

In order to appreciate why a move to change the terms of the Oil Company Government relationship, did not proceed immediately from these criticisms, it is first necessary to set down certain brief data. The following data relate to the number of commercial oilfields discovered, in production, and

under development, at various dates, relating to the 24 commercial oilfields discovered between 1969 and September 1976, which were either in production or under development in July 1980. This list is taken from Klitz (17) with further information on related production data being abstracted from Development of the Oil and Gas Resources of the U.K., (18) other Official sources, (19) and Hoare Govett. (20)

24 North Sea Commercial Oilfields, either in Production
or Under Development July, 1980

	<u>Discovered</u>	<u>In Production</u>	<u>Under Development</u>	<u>Production</u>	
	<u>by the end of</u>	<u>in</u>	<u>in</u>	<u>000's barrels a day</u>	<u>Millions of tonnes</u>
1973	13	0	5	NIL	NIL
1974	19	0	10	NIL	NIL
1975	23	2	8	23) (1))	
1976	24	7	7	237))12.6(2)
July 1980	24	13	11		78.7(3)

(1) Figures in barrels a day to show production build up, as only figure in millions of tonnes in for both years combined.

(2) 1975/1976 combined.

(3) This is a figure for the whole of 1980.

Figures for expenditure in the North Sea are not available prior to 1976, a point emphasised by the Public Accounts Committee, when they drew attention to the lack of cost data which made it so difficult to assess liability for tax. The figures from 1976 to 1980 shown below are taken from the Development of the Oil and Gas Resources of the U.K. (Op.cit).

North Sea Expenditure 1976-1980
(£ million)

	<u>Exploration</u>	<u>Oilfield Development</u>	<u>Oilfield Operations</u>	<u>Gasfield Development</u>	<u>Gasfield Operations</u>
1976	69.7	1507.1	81.3	373.5	48.5
1977	70.4	1555.6	158.9	344.3	47.7
1978	65.2	1690.4	258.2	282.9	87.7
1979	57.1	1841.1	426.6	191.3	92.7
1980	67.4	2163.0	618.5	216.8	107.5

The following table gives the price in \$ U.S. per barrel of Saudi Arabian Light Crude Oil fob Ras Tanura. This crude oil is the OPEC marker crude, which provides a benchmark for other crude oil prices from 1959 to 1975. From 1959 to November 1974, these are given as posted prices, and thereafter in the form of State selling prices, which replaced the former system.

Saudi Arabian Light Crude Oil
fob Ras Tanura
1959-1975

<u>Posted Prices (\$ U.S. per barrel)</u>					<u>State Selling Prices (\$ U.S. per barrel)</u>		
<u>1959 November 1974</u>					<u>November 1974-October 1975</u>		
1959	13/2	1.900	1973	1/1	2.591	1974	1/11 10.463
1960	9/8	1.800	1973	1/8	3.066	1975	1/10 11.510
1971	15/2	2.180	1973	1/12	5.036		
1971	1/6	2.285	1974	1/10	11.651		
1972	20/1	2.479	1974	1/11	11.251		

Source: E.I.U. Special report
No.94 February 1981
OPEC Annual Statistical
Bulletin 1978, 1979.

Considering the Public Accounts Committee Findings of early 1973, which pressed for tax changes and alterations in licensing policy to increase Britain's 'take' from North Sea oil against the background of these three sets of data. The first table which gives brief information on oilfields discovered, in production and under development, shows that by the end of the year 1973, 13 oilfields which were judged to be commercially viable, had been discovered, and 5 of these were under development, but none were so far in production. The second table, covering North Sea expenditure does not cover the years 1973-1975, for reasons already explained. However, the data for 1976-1980 show clearly that by far the largest part of North Sea expenditure related to oilfield development. The table for crude oil prices demonstrates that these prices had already risen quite considerably, well before the dramatic rises of late 1973. All these rises brought with them an escalating drain on the balance of payments, consequent on the costs of importing crude oil, which situation in turn reinforced the British Government's commitment to its rapid development policy, with the intention of staunching this loss at the earliest possible date.

If Britain's balance of payments situation, and the enormous development programme in hand in the British Sector of the North Sea, are for the moment isolated from any international considerations regarding the position of the oil companies in the international oil industry, then conditions in early 1973 were not right for a change in the terms of the Oil Company-Government

relationship in favour of the Government side, since this might will have discouraged the companies at just that time when their maximum effort and investment was required. However, in practice the weakened position of the companies elsewhere (described in Para 3.11) had increased their commitment to the North Sea, where despite the much higher costs of extracting crude oil compared with the Middle East, this factor was compensated for by the political stability of the area and the prospect of an assured source of long term crude oil supplies. Notwithstanding this increased commitment of the companies to the North Sea, which had the effect of strengthening the hand of the British Government should it seek to impose regime changes, the need not to discourage the companies in view of the ongoing importance of rapid development, provided a potent argument in favour of a careful consideration of the nature and timing of such changes. In this context, Patrick Jenkin (21) explained that in 1973, well prior to the Yom Kippur War, the then Conservative Government were already determined to change the regime in order to improve the benefits Britain obtained from the North Sea. With this end in view, they carried out a careful examination of the various options for tax changes, which they considered as an alternative to State participation, a strategy which was also fully investigated. In Patrick Jenkin's view, given that rapid development was still a high priority, an ill judged move against the oil industry which discouraged it from the necessary effort had to be avoided, and whatever the Parliamentary pressure for early changes, it was most important that any proposed package of measures be correct, rather than quickly imposed.

By the end of 1975, the Labour Government which had succeeded the Conservatives in February 1974, had enacted the changes it proposed in its July 1974 Whitepaper. By the end of 1974, 19 commercial oilfields had been discovered and 10 of these were under development, out of the 24 such oilfields discovered prior to July 1980. The Labour Party's view on the measures it judged necessary in the North Sea, had been evolved over a considerable period of time, so that like the proposals of their Conservative predecessors (with which they were broadly in accord with the exception of the creation of E.N.O.C.) their impact had been carefully considered. By the end of 1975, 23 out of the 24 oilfields discovered by July 1980 had been discovered, 8 of these oilfields were under development and two were now in production. The 24th oilfield discovered before July 1980 was discovered in September 1976. Thus by 1975, a substantial part of the most important oilfields to be located in the British Sector of the North Sea had been discovered, a good proportion of these were under development, a couple were in production and the companies' commitment to the area had been reinforced by the weakening of their position elsewhere. Thus conditions were right for the British Government to impose regime changes designed to improve the 'take' Britain obtained from North Sea oil operations, whereas the attempt to impose such changes in early 1973 might have proved premature.

While important oilfields were to be discovered after July 1980, the companies by the early 1980's were pointing to the lack of commercial discoveries since 1976, and suggesting that the application of the tougher tax regime introduced in 1975 was discouraging the industry from the costly exploratory and development activity needed to exploit the smaller and less obviously commercial oilfields, whose viability was influenced both by the

tax regime and the prevailing level of crude oil prices.

3.22 Measures to Stimulate the Development of an Indigeneous Offshore

Supplies Industry The Public Accounts Committee drew attention to the failure of the British Government to take any positive action to stimulate the growth of an indigeneous offshore supplies industry prior to the commissioning of the IMEG Consultants Group in 1972. The unfavourable climate of the early 1960's which brought about the failure of the Ministry of Power's efforts to arrange contracts for British firms in the offshore supplies sector, has already been described in Chapter 1.

Michael Hodges⁽²²⁾ discusses the results of surveys which show that from 1964 to 1970, Ministers of the Labour Government, senior Civil Servants and Conservative M.P.'s predominantly took a positive view of investment by all Multinationals (not just oil based Multinationals) in the U.K. They considered that the Multinationals made a significant impact on the economy in a favourable sense, alleviating balance of payments problems and introducing new technical skills and efficient management. They were considered to be far better corporate citizens than U.K. firms, since they were most anxious not to be in conflict with the U.K. Government. The only doubts about the impact of Multinationals on British industry were expressed by a number of backbench Labour M.P.'s and their views were given scant attention. From 1964 to 1971, very little attention was given in Parliament to the issue of foreign investment in Great Britain, and there were very few cases in which either Labour or Conservative Ministers advocated intervention in the affairs of foreign companies. When this did occur, it was restricted

to those cases, where British companies were taken over by foreign companies (e.g. Rootes) or where the Government had decided to create sponsored companies in certain industrial sectors (e.g. ICL in computers) and these new companies were competing for business with the subsidiaries of foreign based Multinationals. The result of this consensus, was to depoliticise the question of the role of foreign based Multinationals in the U.K. economy, and thus to delay a realisation that in addition to the many benefits these companies brought to that economy, they might also have adverse effects, including in the case of the Multinationals Oil Companies (MNOCs), a tendency to reinforce the market dominance in the U.K. of the U.S. based offshore supplies companies.

Prior to the appearance of the IMEG Report (1972), the Department of Trade and Industry and its predecessor the Ministry of Power, lacked any meaningful data on the levels of expenditure in the North Sea, so that it was not possible to assess the extent of the offshore market. An attempt at such an assessment had been made in 1967, when Sir Ieuan Maddock, the Ministry of Technology's Chief Scientific Advisor had called a three day conference, one of whose objectives was such an assessment. In 1968, a committee of senior civil servants under the Chairmanship of Sir Fergus Allen, made a study of Government policy with regards to ocean technology, and prepared a Report on Marine Science and Technology, in the Introduction to which, Fred Peart made reference to the Labour Government's intention 'to promote the commercial development of general equipment for seabed operations' notwithstanding the fact that in those few passages where the report referred to this issue, the prospect was viewed depressingly in view of U.S. market dominance.

When the Heath Government came to power in 1970, they did so with a policy of general industrial disengagement, which gave little scope for challenging the existing consensus about U.S. market dominance with a policy to promote the development of an indigenous offshore supplies business. Then towards the latter part of 1971, a number of events converged, which brought a change in Conservative industrial policy, and ushered in a more interventionist phase. The collapse and rescue of Rolls Royce and Upper Clyde Shipbuilders through nationalization, signalled that the policy of no help for 'lame ducks' could no longer be sustained and consequently a U turn in policy was under way. As the Government reassessed its attitude to industrial disengagement, it began to take measures for the general stimulation of the economy, and took steps to provide financial aid for industry, which culminated in the Industry Act (1972). Speaking in Aberdeen in December 1971 Sir John Eden, the Minister for Industry at the Department of Trade and Industry, mentioned the great opportunities opened up for British industry by the new oil discoveries in the North Sea. However, Sir John warned that British industry was failing to take full advantage of these opportunities. Reference made earlier to the levels of oilfield expenditure for development, underlines that these expenditures were vast, which emphasises the fact that the great opportunities mentioned by Sir John were not only very great, but very much in excess of the market involved in the earlier development of the southern North Sea gasfields. This combination of a greatly expanded market for offshore supplies with a change of direction in Conservative industrial policy, suggested to officials at the Department of Trade and Industry, and members of the Central Policy Review Staff, that Ministers would soon be in need of a new strategy for stimulating the growth of an indigenous offshore supplies industry within the U.K. (23) In anticipation of this need, they

took a policy initiative, by jointly commissioning the IMEG Report, the object of which was to identify means for stimulating the growth of a U.K. based offshore supplies industry. (Footnote*).

When Labour took office in 1974, the OSO played some part in industrial reorganisation, as for example when British Underwater Engineering was formed under the N.E.B., when Vickers withdrew from subsea engineering. In 1975, there was introduced the Memorandum of Understanding, by the signature of which, the oil companies accepted the formal principle of 'full and fair opportunity' for British suppliers. In practice, the influence of the OSO was exercised most effectively through its association with the Department of Energy. Performance of oil companies in respect of using British suppliers, became a factor in the allocation of licences under the discretionary

Footnote*: Notwithstanding the interventionist phase which Conservative policy had now entered, some of IMGE's recommendations proved too interventionist for the Government so they were ignored.⁽²⁴⁾ An Offshore Supplies Office (OSO) was set up, initially under the DTI, though it later moved to Glasgow under the Department of Energy. Using the leverage they possessed under the Administrative Allocation Licensing System, the Government required the companies to submit quarterly returns of their expenditure, which were audited by the OSO, which also monitored the progress of U.K. firms in offshore supplies, and cleared away any administrative problems in the way of their acquiring contracts (e.g. help was provided on planning permission). For administrative convenience, Interest Relief Grants were paid to the oil companies, to compensate British suppliers for the subsidies received by foreign suppliers.

application of the Administrative Allocation Licensing System. Though the consequences of failing to buy less than a good proportion of company requirements was nowhere specified, the force of the situation was fully recognised. (Footnote*)

(Footnote*) By 1984, the situation had changed to the extent that 70% of offshore supplies used in the North Sea come from British suppliers. The companies have publicly stated their commitment to the use of British suppliers.⁽²⁵⁾ However, the price of crude oil, which reached around \$ U.S. 40 a barrel at the end of the 1970's has now dropped to around \$ U.S. 30 a barrel. The cost of producing North Sea oil is high, at around \$ U.S. 12 per barrel and it has never been cheap compared with other producing areas. Thus Shell and Esso⁽²⁶⁾ while identifying the need to develop some 60 to 90 new fields in the North Sea to provide for longer term requirements, are now highlighting those phases of the businesses where U.K. performances can be improved, seeking to achieve a 15% cut in costs through better project management in co-operation with suppliers, and pointing to the incentive of the much higher levels of investment required to exploit the smaller deposits under consideration.

3.23 Depletion The Public Accounts Committee did not recommend any change in the policy of rapid development, but observed that successive Governments since the start of work in the North Sea had felt:

'that the balance of advantage to the United Kingdom lay in exploiting and extracting these reserves of oil and gas as quickly as possible.

In arriving at this decision they took into account relevant factors,

including balance of payments savings, security of supply, possible future fuel shortages'

Despite this view, Department of Trade and Industry witnesses stated that a review was in progress to determine 'whether there would in certain circumstances be advantage in delaying the exploitation of our own resources of oil rather than expediting them'. By July 1974, the Labour Government's Whitepaper 'United Kingdom Oil and Gas Policy' stated:

'The Government will therefore, for current as well as future licences, take power to control the level of production in the national interest. This does not effect their determination to build up production as quickly as possible over the next few years. The question of reducing the rate of depletion is unlikely to arise for some years but the Government believe they should take the necessary powers now'.

There was little contention over the issue of taking these powers to control depletion, since the Conservatives also took the view that it might be necessary to control depletion in the future, which they proposed to do through the mechanism of their intended United Kingdom Oil Conservation Authority. Given the concentration of northern North Sea oilfields within the area of what would be the North Sea Sector of an independent Scotland, the Nationalists favoured a policy of slow development, with a production ceiling of 50 million tonnes a year. With this exception, how did the consensus between the two main Parties in favour of future control of depletion come about?

The events of late 1973, which resulted in a greater degree of uncertainty in the international oil market, which was no longer dominated by the Multinational Oil Companies (MNOCs), led to an increased priority being placed on security of supply by all Western Governments. An indigenous source of supply such as that under development in the British Sector in the North Sea was completely secure. As expectations of rising crude oil prices took shape, it seemed only realistic to keep a supply of crude oil in the ground in anticipation of further rises. Moreover, as crude oil prices rose, so to did estimates of the crude oil reserves located in the British Sector. While it seemed entirely right to both Conservative and Labour Governments, that the rate of extraction of southern North Sea gas should be substantially producer determined, to compensate them for the poor unit price per therm they were receiving, the same could not be said in respect of the rate of crude oil production.

The work of Jay Forrester⁽²⁷⁾ in the late 1960's on natural resource depletion had been followed by the still more widely disseminated work of D.L. Meadows⁽²⁸⁾ and the Club of Rome, which impressed upon informed opinion the fact that natural resources such as crude oil were ultimately finite and ought therefore to be husbanded. Robinson and Morgan⁽²⁹⁾ emphasise the general point that the more rapid the rate of oil extraction, the smaller the total quantity of oil ultimately extracted. While Robinson⁽³⁰⁾ suggests that increased public awareness of the importance of energy as a result of the oil crisis of 1973/1974 made politicians realise that there were votes to be captured through being seen to do something about energy, it is probably fairer to say that as a result of those events energy matters were placed higher on the political agenda. Robinson's observation,

was made as part of the argument suggesting that the market is a superior determinant of depletion rates compared with Government action, since in his view, even if short term political considerations are excluded from Government decisions, he doubts if British Governments are capable of optimising depletion rates, given their poor record of economic management since the war.

Extensive powers to control depletion were taken by the 1974-1979 Labour Government, in the Petroleum and Submarine Pipelines Act, 1975 and the Energy Act, 1976 and in Chapter 5, the manner in which these powers were exercised in 1980/1981 in respect of the Clyde Field development decision will be considered. However, in the mid 1970's the Government were anxious to assure the oil companies that depletion control was a consideration for the 1980's rather than for the immediate future, and in late 1974, Eric Varley proceeded the legislation, with these (non legislative) guidelines, which became known as the Varley Guidelines:

(1) Finds made before the end of 1975 under existing licences

No delays would be imposed on development plans. Any production plans would not be applied before 1982, or four years after the start of production, whichever is later.

(2) Finds made after end 1975 under existing licences.

No production cuts would be made before 150% of the investment made in a field had been recovered.

- (3) Development delays on finds made after the end of 1975 would only be made after consultation to avoid premature investment.
- (4) Any production cuts imposed would recognise the technical and commercial factors involved in the field concerned and would not exceed 20%. Consultation would take place to determine the appropriate period of notice before the cuts had to be effective.
- (5) In considering any production cuts and development delays, account would be taken of the interests of the offshore supplies industry.

3.3 The Gas Regime When the Public Accounts Committee drew attention to the poor 'take' from North Sea taxes, licences fees and royalties, they considered that as regards the southern North Sea gasfields (for the exploitation of which the existing fiscal and licensing arrangements had been established) this adverse effect was substantially mitigated by the economic and other effects resulting from the involvement of the Gas Council in the enterprise. The Committee's concern was to highlight the dangers of continuing these same fiscal and licensing arrangements for the exploitation of the northern North Sea oilfields, where the enterprise was entirely in private sector hands. The Gas Council's involvement in the southern North Sea gasfields took two forms. Firstly, the Council had a direct stake in the discovery, development and production of some of these gasfields, and were involved in operations, as a result of which their technological expertise was enhanced and their degree of dependence on the oil companies was correspondingly reduced. Secondly, the Council was the sole or monopsony buyer of North Sea gas, unless this was to be used for non fuel purposes,

which in effect means chemical feedstock. Should there be a failure to agree a price between the Gas Council and the companies, the Minister of Power had the right to intervene to secure a settlement. These conditions formed a considerable countervailing power enjoyed by the Government to offset the liberal financial conditions enjoyed by the companies. The Minister of Power, could if he wished, grant a producer the right to sell gas outside Britain, but in practice the U.K. placed an embargo on the export of gas, which complemented the Council's position as monopsony buyer. Despite repeated calls from the companies to end this embargo, it has been maintained up to the time of writing.

From the first discovery of the West Sole gas field in October 1965, interest was centred on the economic and social aspects of converting the whole of the U.K. gas supply industry to the use of North Sea gas. As the remarkable extent of the ensuing discoveries became clear, a final decision was taken in 1967 to abandon the production of all manufactured gas produced by the Lurgi process and carbonisation.⁽³¹⁾ However, in the decade preceeding this decision a massive investment of public money had been made in order to re-equip the gas manufacturing industry, so that the decision to convert the natural gas, required a writing off of £400 million of capital expenditure, well before the end of the new equipment's life. Manufactured gas has a calorific value of 500 BTU, and North Sea gas has a calorific value of 1,000 BTU, and this made it necessary, either to reform the North Sea gas so that it could be accommodated by the existing equipment, or to totally convert the domestic burning appliances. The total costs involved after a decision had been taken to convert the domestic burning equipment consisted of two elements:

Coastal pipelines and terminals	£2,000 million
Writing off manufacturing equipment and domestic appliance conversion	£1,027 million

It was found that North Sea natural gas would have to meet the requirements of three markets.

- 1) The Premium Market This was the market in which North Sea natural gas showed a substantial premium advantage over other fuels. In 1960, this market consisted of 13 million domestic users and 80,000 industrial users.
- 2) The Semi Premium Market This was the market in which North Sea natural gas showed a small competitive advantage over manufactured or town gas prepared from coal or oil, although this competitive advantage (in 1967/1968) was much smaller than the margin in (1) above.
- 3) The Bulk Industrial Market This market required the greatest crude heat, offered at the lowest price per therm, so that in order to succeed in this market, North Sea natural gas would have to be sold at a very low price indeed, compared with coal or oil.

The Premium and Semi Premium markets, some displacement of coal would result. Without natural gas, the premium market would have to be supplied with gas made from imported oil, and the semi premium market from liquid petroleum products at the lighter end of the range. The use of North Sea natural gas, it was estimated, would save £50 million by 1970/1971. In the

absence of North Sea gas, further investment would be needed in conventional gasmaking equipment. It was decided the cost of writing off the considerable public investment in gasmaking equipment should not be a charge on North Sea gas. The National Coal Board (32) made the point very strongly, that in the Bulk Industrial Market, where natural gas would be offered at very low prices in order to make it competitive with other fuels, this strategy would result in the closure of a substantial number of pits, and the writing off of many millions of public investment, in view of the loss of the market. The Ministry of Power carried out a most searching investigation of all the possible consequences of conversion, and in support of this, a Pilot Project based upon the conversion of domestic burners was carried out in Canvey Island in 1966, prior to a final decision.

As a result of the foregoing analysis, it was concluded that the payment of a low price to the gas producers, would enable the gas industry to keep prices at a satisfactory level in the semi premium and bulk industrial markets. The first company to negotiate a price for the delivery of gas to the Gas Council, was BP, which as the first company to reach such an agreement with the nationalised gas industry for the supply of indigeneous natural gas, were able to obtain a price of 5 old pence (2.083p) per therm, following the intervention (4/2/65) of the Minister, Fred Lee. It was made clear at the time that this was an incentive price paid to BP in recognition of their decision to press ahead with the necessary development. Nevertheless, since the Gas Council had obtained a supply of gas at a level well below either the cost of manufacturing town gas, or importing gas from Algeria, the other companies believed that they might expect roughly equitable treatment. Thus when negotiations opened in 1966, these other

companies (who negotiated cartel like as a group) were surprised to find the Gas Council was offering them a price of 1.8 old pence per therm. During the following 2 years of negotiations, all arguments by these companies to the effect that they had been induced to go ahead with development on the prospect of obtaining a price similar to that paid to BP failed to move the Gas Council from its position.

The negotiating process between the Gas council and the companies, which also involved interventions by the Minister of Power, brought Dennis Rooke to the fore on the Gas Council side. Dennis Rooke was a professional engineer who had been involved in organising the natural gas supply grid, and the import of Algerian LNG (liquid natural gas) using the Methane Pioneer, a ship especially designed for that purpose. The Gas Council took the position that notwithstanding the international market price for gas, the price paid the companies should consist of the price of bringing the gas ashore, plus a relatively small premium as a reward for their enterprise in having found the gas in the first place. (33) the Government, represented by the Minister of Power, took a broadly similar view of the issue, except that they felt that the price paid the companies should be rather better, as an incentive for the future exploration.

With the negotiations dragging on, the companies investigated any means which might help them to get round the legislative requirement forcing them to sell to the Gas Council for other than non-fuel (principally chemical feedstock) purposes. The companies used Lord Robens (paradoxically, he was at that time Chairman of the NCB) as their Lobbyist. He sought to convince his former colleagues in the Labour Government of the need for an improved

price. He also suggested to them that some gas might be sold to the C.E.G.B., for use in an East Coast power station. Conoco, recognising that they could obtain 3 times the Gas Council's offer by selling their gas abroad, sought the Government's permission to export, which was technically possible under the legislation, given official agreement. This permission was refused, thus effectively establishing an embargo on gas exports, which was thereafter maintained to support the Gas Council's position as a monopsony purchaser of North Sea gas. The Government has possessed and where it judged necessary, exercised the power to prevent the export of both oil and gas since 1939 under the Defence Regulations, and this power has been restated in subsequent legislation, notwithstanding that it may be technically contrary to the Brussels Treaty. In this context, it is interesting to note that in May 1984 the Netherlands had just ended a 10 year embargo on the export of their gas.

Two further options existed for the companies in seeking to avoid sale to the Gas Council. Firstly, they could use the gas a chemical feedstock, most practically at that time, to produce anhydrous ammonia for use as a fertiliser, except that the quantities of gas available were well in excess of the amounts needed to fully supply that market. Secondly, through an apparent loophole in the legislation, there was one way in which they might export the gas. Conoco's thwarted attempt to export gas involved piping it abroad, which required Ministerial consent, but if the gas was liquefied for export in containers, this did not require such approval, except that the costs associated with such a proposal, given the quantities involved, made this outlet commercially unviable, with which fact the Gas Council and the

Minister were well aware. Assuming that the Government had agreed to the piping of gas abroad in the 1960's, such a course would have been politically difficult, given the opportunities to use the gas in the U.K. economy and the visibility of the action given contemporary public expectations of 'cheap' gas.

As the negotiations extended into 1968, the Government made it clear that unless they were brought to a speedy and satisfactory conclusion they might not permit the Gas Council to purchase gas produced from the smaller gas fields, and this had the effect of breaking the common front till then maintained by the companies. Arpet and Conoco, were involved in one of these gasfields, the Hewett Field, and the Government's threat led them to settle at a price of 2.87 old pence per therm. The other companies maintained a rearguard action for a time seeking a recognition of the 1967 U.K. currency devaluation. Finally, Shell/Esso agreed to a price of 2.83 and 2.87 old pence per therm depending on the rate of daily delivery, and Amoco settled at 2.90 old pence per therm.

At the time when the settlement was finally reached, the National Executive of the Labour Party were pressing the Government to extend public ownership to oil and gas through the setting up of a National Hydrocarbons Corporation (which the Government judged incompatible with rapid development) and had the companies continued to stand out against a settlement on lines acceptable to the Government, this would have provided the Left on the N.E.C. with a valuable argument to use in pressing its case.

Notwithstanding their final reluctant acceptance of terms, the companies maintained that the price they received was inadequate to justify the exploration needed to secure the long term supplies required by the U.K. gas industry, which would involve the development of newer and smaller gasfields. This claim can be investigated from several points of view. Would exploration levels have improved in response to a better price? Are adequate quantities of gas available from British and foreign sources to meet current requirements? What adverse consequences follow, if imports from foreign sources are required to meet British requirements?

Peebles (1980) states: (34)

'It is impossible to say beyond dispute whether the exploration effort would have been substantially greater if the long term contracts negotiated in the later 1960's had been more attractive to the producers.'

While Dam (35) writing in 1970, states that at that time there was no evidence of a drop in exploration effort, while Peebles (in the work previously cited) explains that by August, 1971, of the 79 southern North Sea Blocks offered in the 4th Licensing Round, only 21 were taken up, but this may well have been due in some measure to the fact that by that time, interest had passed to the more exciting oil prospects further north. As regards the future availability of supplies, Peebles estimated that these might prove to be from all sources, and with hindsight from the standpoint of mid-1984, these seem more that adequate given the present excess of supplies over demand in a European context. (36) However, for sometime there has

been a shortfall between British Sector gas supplies and U.K. gas demand, which has been substantially met from Norwegian sources. In May 1984, a British Gas contract to purchase £20,000 million of gas from the Norwegian Sleipner Field (31% Exxon interest) over 15 years was under consideration. The Treasury view, notwithstanding the British Gas opinion that it was good deal, was that it might be better to spend money on finding and exploiting further gasfields within the British Sector, an attitude supported by BP, who pointed to the benefits of this course of action for employment in particular, and the UK economy as a whole.

3.4 Summary of Conclusions When in 1973, the Public Accounts Committee called for changes in the fiscal and licensing arrangements for North Sea operators, they had in mind the inappropriateness of these arrangements for the exploitation of oilfields in the Northern North Sea, where unlike the southern gasfields, conditions were not mitigated either by an element of State participation, or the monopsony purchase system. (Para 3.2).

In view of the early stage reached by 1973 in the exploitation of the northern North Sea oilfields, having regard to the number of oilfields discovered, under development and in production, it would have been premature for the Government to have stiffened the terms for the companies at that time. To have done so might have lessened company commitment to the area where so much of the most costly work remained to be done. (Para 3.21).

When wide ranging changes were introduced by the Labour Government in 1975 exploitation was further advanced, and while in terms of the model derived from Hossain it might still have been premature to have introduced

stiffened conditions for operators, by that time, changes in the worldwide oil industry, the origins of which lay well prior to the oil crisis of 1973, had matured to such an extent, that the global position of the oil companies was irrevocably weakened and their commitment to the North Sea thereby increased, which strengthened the hand of the British Government in the Oil Company Government relationship (Para 3.21).

Government measures to stimulate the development of an offshore supplies industry were delayed not only by the requirements of rapid development policy (Chaper 1) but also because such action would have been inconsistent with the first non-interventionist phase of the Heath Government's economic policy. The IMEG Report coincided with a change of Conservative policy in favour of a more interventionist approach, though change to a still more thoroughgoing Government involvement had to wait till Labour came to power in 1975, when the leverage of discretionary licensing was applied to secure a fuller use of British offshore supplies. In recent years, the oil companies have themselves become fully committed to maximising the use of the British offshore supplies industry (Para 3.22).

Notwithstanding the fact that the Public Accounts advocated no changes in the rapid development policy, the introduction of powers to control depletion and the Varley guidelines on their future application derived from a heightened perception of the dangers of natural resource depletion and the fact that due to the 1973 oil crisis, security of energy supplies was now higher on the political agenda. (Para 3.23).

The system whereby the Gas council was the monopsony (or only) buyer of gas, combined with the ban on the export of gas piped abroad, plus the fact that the permitted alternative uses (as chemical feedstock, or for export after liquefaction) were not viable, shifted the balance of advantage to the Gas Council in their negotiations over price with the companies. While the companies claimed the prices received were insufficient to stimulate the exploration needed to produce future long term supplies it is not possible to say with any certainty that exploration effort would have been increased by the payment of a price more favourable to the companies in the contracts negotiated in the late 1960's. While the quantities of gas presently available from domestic and foreign sources are more than adequate, the cost to the balance of payments of contracts for long term gas supplies from abroad to meet the shortfall between UK demand and British Sector production, does raise the related question of whether the money might be better spent on maximising British Sector reserves (Para 3.3).

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Chapter 4 State Participation: The Establishment and Subsequent Development of the British National Oil Corporation (B.N.O.C.)

4.1 Introduction Chapter 3 demonstrated that combination of circumstances, arising from changes in the international oil industry and the state of development of the northern North Sea oilfields, which strengthened the hand of the British Government in the Oil Company Government relationship, and thus made possible the regime changes of 1975. This changed situation reduced those constraints which has thus far contained policy within a bipartisan framework, and from 1975 onwards the North Sea policy of the two Parties progressively diverged along lines determined by their ideological views on the proper means for organising industry. This divergence first manifested itself in 1975, when the Labour Government decided to introduce State participation into the North Sea (in existing licences) as a means of extending their control over oil and gas operations, and established the British National Oil Corporation (B.N.O.C.) as an instrument for this purpose. Their Conservative predecessors were also committed to extending State control over the North Sea, though by different means, and as with Labour this commitment proceeded in some measure from their past experience of British Government relationships with BP, which will be considered in Para 4.21. The Conservatives proposed means for extending control over the North Sea involved the creation of a regulatory agency, designed on North American lines, to be called the U.K. Oil Conservation Authority.

The roots of this difference in approach will be established in Para 4.22, which considers the debate between the two Parties on the setting up of

B.N.O.C., and the progressive divergence of their North Sea policies, will be illustrated through the history of the Corporation, first under Labour from 1975 onwards, and thereafter under the Conservative Government from 1979 onwards. In Para 4.3, B.N.O.C. under Labour, it will be shown how the Corporation's Board was carefully constructed to exclude oil industry influence, and how the resulting management then worked in close concert with the Department of Energy to secure agreement to State participation in existing licences, from a reluctant oil industry. The manner in which the Corporation obtained some degree of financial independence from the British Government by negotiating the Britoil Loan from a consortium of U.S. Banks will be explained, and it will be shown that by securing this loan against the future revenues from crude oil sales, some counter was provided against any plans by a future Conservative Government to introduce privatisation. Para 4.4, B.N.O.C. under the Conservatives, will cover Conservative attempts at privatisation, and the manner in which these were initially frustrated by Lord Kearton, who argued that selling off wealth creating assets, would deny the Government a future stream of profits. It will then be explained why the Conservative Government had returned to its first objective of privatisation by the end of 1981, and at that time seemed likely to push its objective to completion, as was finally achieved in 1983. Chapter 5, will deal with the broader development of Conservative policy, from 1979 to 1981, as illustrated by two Case Studies, the Gas Gathering Line Case Study, and the Clyde Field Development Delay Case Study.

The creation of B.N.O.C. introduced a new and crucial element into the bargaining relationship between the British Government and the oil industry.

While the formation of the Corporation was in this sense a purely British event, it was also part of an international trend whereby National Oil Companies (NOCs) were assuming greater importance in the international oil industry, as part of that process of change already described in Chapter 3. In the decade from 1970, the share of the Multinational Oil Companies (MNOCs) in the international oil trade has declined from 70% to 50% ⁽¹⁾ a large part of this loss being taken up directly by the activities of NOCs. That part of the 20% not attributable directly to the activities of the NOCs results from the growth of the spot market, a free market for crude oil to which both MNOCs and NOCs have access. For these reasons, the position of NOCs in the wider international context must be considered before turning to the development of B.N.O.C. in its domestic political setting. Para 4.11 The Rationale of the National Oil Company, establishes the purposes behind such companies and the motives which cause Governments to form them, contrasting their objectives with those of the MNOCs. Para 4.12 The Growth of National Oil Companies, goes on to explain why these companies have achieved greater importance within the international oil industry, since 1970.

4.11 The Rationale of the National Oil Company The structure of an industry reflects the economic and social conditions of the period in which it operates, ⁽²⁾ and throughout much of the present Century the predominant form of enterprise in the oil industry has been the Multinational Oil Company (MNOC) the nature of which was described in the last Chapter. To assist the present argument, the principal characteristics of the MNOC will be briefly restated. It is large (i.e. horizontally concentrated), because both the risks and capital expenditure involved in the oil industry are great. It

extends over most countries of the Free World (i.e. it is horizontally integrated), and it is vertically integrated, because if you produce crude oil it makes good commercial sense to refine it and sell the resultant products, in order to capture the full value added. In its ideal form, an MNOC seeks crude oil wherever it can profitably find it, refines it in whatever location suits the best interest of its business, and sells its products in every profitable market. Indeed, till the 1970's when changes in the industry reduced their global rate of profit, such companies would often operate in unprofitable markets to exclude competition. Thereafter, they were forced to be more selective in their choice of markets. Such companies are said to operate on the principle of global optimisation, which with its large economies of scale has brought great benefits to most of the countries involved in the system. However, such benefits have always been economic benefits, and even when the system has operated at maximum efficiency, it has been sub optimal economically for some of the countries involved.

Where, for a particular country, the results of global optimisation operated by MNOCs have proved sub optimal in the economic sense, this has provided clear economic grounds for Governments to intervene in the industry. Such cases explain only a minority of those occasions when Governments have decided to set up NOCs. As Leslie Grayson observes, (3) where economic and social factors have been involved, these have normally been of secondary importance. Grayson's point is illustrated by the three following examples of European State petroleum enterprises, established for primarily strategic reasons.

The first State petroleum enterprise established, (4) was set up in Austria in 1907. In that year a large oilfield had been discovered in Galicia, at a time when World crude oil demand was adequately catered for by oil production from Roumania, Russia, Mexico and the U.S.A. As a consequence of the new discovery the first international crude oil glut occurred. The military authorities in the Dual Monarchy, appreciating the strategic value of a domestic source of refined products, wished to have Galician crude oil refined locally, and when the oil industry was unable to reconcile this requirement with their own attempts to solve the wider economic imbalance, the Austrian Government built their own refinery at Drohobycz in the centre of Galicia, with a capacity of 100,000 tons of crude oil per annum.

Chapter 1 emphasised the great importance which oil products attained during the First World War, and mentioned in particular that occasion in November 1917, when France came close to defeat due to the near exhaustion of her petrol supplies. In the post war years, as a result of this wartime experience, the French Government set up CFP (Compagnie Francaise des Petroles) to control the stake in the international oil industry which had been acquired from the defeated Germans. Within France, the domestic arm of CFP carried through an extensive refinery building programme, and set up a comprehensive marketing infrastructure. Many of the installations built in France by CFP, and many of their marketing activities, could not be justified on economic grounds. These activities, known as the Regie Autonome, were set up for primarily security reasons.

In like fashion, the Italian State Company AGIP, was set up between the

Wars to promote national security, by reducing Italian dependence on the international oil industry, dominated by the Anglo Saxon based companies, BP, Esso and Shell. Refineries were built and a marketing infrastructure set up, while widespread exploration effort was applied both at home and in the Italian African territories. Perhaps ironically (in view of the post War development of Libya as a major crude oil producer) all these activities were a more or less total failure due to the inability to locate any crude oil deposits, so that Italy lacked the necessary crude oil base for these autarchic schemes.

For the management of a State enterprise commercial success and a steady stream of profit provides a bridge between its commercial objectives, and any non commercial objectives of its Government . The potential conflict between these differing ends is ever present, but without commercial success there is a greater likelihood that this conflict will surface. Yet to be commercially successful a State enterprise needs a dynamic management, and when such management achieves success, this tends to draw the enterprise away from State control. The post World War II history of the French and Italian State petroleum enterprises illustrates these problems. After the Second World War, Italy created a new company called E.N.I. (Ente Nazionale Idrocarburi), to operate in the international oil industry, leaving AGIP to handle domestic marketing within Italy, while in 1953, France set up SNEA (Societe Nationale Elf Aquitaine) to manage her 'national' crude oil resources within the then French Colonies. E.N.I. (5) became a highly successful company, pioneering many of the new joint ventures in exploration and production, and thus

challenging the dominance of the Multinationals. In this process, the company (in particular its vigorous leader, the late Enrico Mattei) achieved a high degree of independence from Government control.

Within France, CFP has faced an ongoing conflict with the Government over the requirements of the Regie Autonome, under which the company has to maintain unprofitable activities and installations, in order to retain a dominance over the domestic market, which its management would prefer to lose. This parallels the situation of Air France, which is forced to maintain unprofitable routes to former Colonies, and to the Overseas Departments, for various reasons of prestige and security. Such situations raise the issue of whether the Government or the State Company, are to decide the tradeoff between political and social objectives, and the return on capital employed.

To create a State enterprise in a mixed economy, which will compete with the private sector, a Government has to provide special support to the company in the early stages of the enterprise, and on later occasions when operating conditions become difficult. In these circumstances, such State enterprises are said to 'sail in the national direction when the wind is behind them, and in the commercial direction when the wind is against them'. The management of a new NOC set up in these conditions, if at all worth its salt, will take full entrepreneurial advantage of all the special support provided by its Government, which leads the private sector to perceive such special support as unfair, especially if the NOC is commercially successful.

Grayson (6) considering Western European NOCs, outlines the objectives of such companies as follows:-

- (1) To reduce dependence on MNOCs. Till the advent of these NOCs, MNOCs dominated West European crude oil supplies, through their control of low cost crude oil.
- (2) To gain a real understanding of the oil business. In order to obtain from the oil industry as a whole the information it needs for economic and energy management, the Government needs to know what questions to ask, and how to interpret the answers. Direct experience via an NOC will provide them with the expertise needed for this task.
- (3) To obtain better deals from OPEC countries on an NOC to NOC basis.

As regards the ability to properly interpret oil industry data, Odell⁽⁷⁾ doubts if B.N.O.C. adequately carries out this function, for he considers that the interpretation of information from the North Sea, on which estimates of the oil and gas reserves for the British Sector are based, has been so permeated by an oil company view, even within the Corporation, that these reserves are consistently underestimated. However, in practice there are several divergent views on the issue of estimating oil and gas reserves, which is amongst the most controversial of forecasting activities, and notwithstanding the increased attention paid to the matter since 1973, which has produced many models, techniques and estimates, questions relating to the

proper information needed to assess the resource base and the role of technology in its future recovery are still the subject of a wide debate.⁽⁸⁾ That estimates of recoverable reserves vary both overtime and according to the estimation technique used is clear from the work of Meyer (1977)⁽⁹⁾ and Odell and Rosing (1980)⁽¹⁰⁾.

The objective of obtaining better deals from OPEC countries for the supply of crude oil, through NOC to NOC deals has not been achieved, for experience shows tht OPEC NOCs operate firstly in their own national interest. Indeed, probably because of the ongoing business relationship between the MNOCs and the producing countries, deals between MNOCs and the producing countries have generally had a superior outcome from a Western standpoint. The value of NOCs as a means of reducing countries dependence on the MNOCs has also varied, because some countries such as Norway and Great Britian have their own crude oil, and are not dependent on imports. There has been a considerable variation in the importance attributed to these three objectives by the different European countries, which may well be a factor underlying their inability to establish a common European energy policy.

The expression l'enterprise temoigne, refers to an enterprise which bears witness, and as applied to an NOC in a mixed economy this means that the NOC acts like an MNOC, and competes with MNOCs, so as to provide its Government with a standard against which to judge the activities of MNOCs. The concept suffers from two weaknesses. Firstly, the scope of an MNOC is international, while the scope of an NOC is primarily national, not-

withstanding those instances when NOCs enter into exploration and production ventures overseas, or engage in international oil trading on the basis of their indigenous sources of crude oil. Secondly, an NOC has social and political objectives, which may distort its ability to act like a true MNOC. Even though MNOCs have social and political objectives (for example, social responsibility programmes involving work in the community) such objectives are clearly subordinate to, and supportive of their primary aim, which is to make a profit.

The French experience of CFP, supporting non commercial activities for other than business ends, suggests a generalised role for NOCs, which is to carry out this work in those parts of the oil industry where the MNOCs will not operate, since there is no profit in it for them, more particularly those activities the MNOCs have progressively surrendered from 1973 onwards, as a result of the squeeze on their profit margins. Such a role, if widely extended, could only increase the risk of conflict between an NOC and its Government.

4.12 The Growth of National Oil Companies The strategy of creeping nationalization, whereby producing countries progressively extended State participation and their control over the oil industry has been described in Para 3.11 (of the last Chapter), Regime Change in the World Oil Industry. The process of change outlined, necessarily increased the importance of NOCs within those countries in the years up to 1973, when that process culminated in a visible demonstration of the power of the OPEC countries. As a collective response to the Arab Israeli conflict, the Arab OPEC members

restricted their production, and placed limits on the supply of crude oil to the Western countries. The Arabs, who on the basis of the Suez Crisis (1956), and the 6 Day War, were judged incapable of a sustained common effort, now acted in just such a way to reduce the flow of oil to the West. Supplies were curtailed on a scale, which was alleged to correspond with the degree of sympathy for Israel in each Western Government, or alternatively, their extent of support for the Arab cause. Thus the U.K. and France were both judged favourable to the Arab cause, and suffered a 10% reduction, while the Netherlands, whose Government was considered to particularly favour Israel, suffered the maximum discrimination, even though the real cause of this treatment was the Arab recognition of the widespread trouble that would follow their decision, since Rotterdam was the centre of the West European oil trade.

Differential discrimination by the Arabs was one of two factors which weakened the chance of a collective response by the Western Nations to the crisis. The other factor limiting the chances of such a collective response was the varying extent to which the various Western countries were dependent on imported crude oil. Thus by 1973, Norway was totally self sufficient in crude, while Great Britain expected to become so in the future, but Japan was totally dependent on imported crude oil. As a result of this situation, each of the Western countries sought to make its own special arrangements with the producing States, particularly the important non Arab producing States, such as Venezuela and Iran. It was in this contact that British Ministers flew to St. Moritz to seek the special favour of the Shah. These initiatives reinforced the demonstration of power by the Arab States, so that all the oil

producing nations were perceived as powerful.

Since neither the oil companies or the Governments of the Western States had made any preparations equal to the scale of the restrictions, not withstanding the stocking obligations introduced by the E.E.C. in 1968, the effectiveness of the Arab challenge demonstrated both to the Western Governments, and to the producing States, that the MNOCs were now in some ways powerless in the face of determined action by a host country. This stimulated the desire of all host Governments to participate further in all phases of the oil industry, and thus gave an extra stimulus to the growth and significance of NOCs. For example, 1978 saw a total takeover of the domestic oil industry within Venezuela, carried out amicably in co-operation with the oil companies, whose primary interest now lay in preserving their crude oil supplies.

Within Western Europe, not only were most countries dependent to varying degrees on the Arab States for imports of crude oil, but within these countries, the refining marketing and transportation facilities were under the control of the MNOCs, so that the Governments were in this respect dependent to varying degrees on the oil companies. Those Governments who were not home Governments to the MNOCs (all apart from the U.K. and Holland, together with France if ELF ERAP is included) feared that the companies would discriminate in favour of their home states, and when they subsequently acted equitably to all their customers this was immaterial, serving only to demonstrate to all Governments their powerlessness, and the extent to which they were dependent on the companies. While tax measures might be quite

adequate as economic instruments to cream off oil company profits, energy had now become a matter of visible public concern, so that such measures in themselves were politically inadequate, and it became necessary to demonstrate to electorates that something was being done. The formation of a National Oil Company was a clear demonstration of action.

Within the U.K. the Heath Government attempted to obtain preferential treatment from BP and Shell, and their failure to achieve this objective, will be covered fully in Para 4.21, The Relationship between the British Government and BP. In the circumstances of 1973, the Government urgently required information on the oil stocks position, and the crude oil and products in transit. They found difficulty in probing and questioning such data, so as to form a proper basis for decision making. Speaking of this situation in an Open University Programme (11) Peter Walker explained the situation as follows:-

"You obviously called in the oil companies, as I did, and asked them what the position was as far as stocks and what would come to Britain, and what was on the seas to Britain and so on. And the figures you had them to check and see how good they were and so forth. But... the oil companies operate internationally and as such you couldn't rely upon them being particularly favourable to you as opposed to any other countries they were supplying. And you had to therefore negotiate with them and obtain what information you could as to what oil was coming out of various countries and say to them 'Look this amount is coming out of

these countries, on the proportion of our normal share we expect to obtain at least this'. And therefore you were constantly pressurizing them to get the maximum you could from the available supplies on the high seas".

Geoffrey Chandler, for Shell, speaking on the same programme explained:-

"From a number of governments we came under very severe pressure to give them preferential treatment, but when we asked and this was particularly true of Britain and France - when we said if we favour you who should go short, we in fact got no answer and what we therefore did in the absence of any government ruling was to try and administer the shortage equitably... to equalise the misery so that everyone went short by about the same amount... although we were vilified at the time we have been fully vindicated since."

The effect of this situation was to demonstrate to the U.K. Government its powerlessness. The other Governments of Western Europe found themselves in a similar position, irrespective of whether they were the home Governments of MNOCs or not, so that a sense of powerlessness in the consuming countries, combined with a sense of increasing power in all the producing countries, to stimulate the growth and significance of National Oil Companies. Oil was far too important a business to be left entirely to the oil companies.

4.2 Setting up B.N.O.C. : The Background and the Debate

4.21 The Relationship between the British Government and BP Both the Conservative and Labour Parties were equally determined to extend Government control over the North Sea oil industry, though they differed on the means of achieving this. The nature of these differences will be demonstrated in Para 4.22, but it is first necessary to explain how the experience of both parties while in Government, with respect to their relations with BP, contributed to the view they held in common, that Government control must be extended over North Sea oil. The clearest outline of relationships between the British Government and BP is derived from a report by Krapels ⁽¹²⁾ made to the U.S. Senate.

The origins of the British Government's involvement with BP has been described by Geoffrey Jones. ⁽¹³⁾ There was a steady growth of interest in fuelling ships with oil, beginning in 1865. Although at first inhibited by technical problems, these had substantially been resolved by the turn of the Century when Admiral Fisher, known as the oil maniac by his naval colleagues, was in charge of the Admiralty. Thereafter, the move to oil to fuel the British Fleet was constrained by other factors, principally the fact that the British Empire lacked any significant oilfield, combined with the important consideration that South Wales coal was cheaper than oil. As a result Fisher's revolutionary Dreadnought battleship remained coal burning. In 1912, Churchill secured Government approval to build a squadron of oil fuelled ships. Subsequently, as a logical extension of this decision, the British Government, at Churchill's suggestion, purchased a controlling

interest in the then Anglo Persian Oil Co. Ltd (subsequently A.I.O.C. and then BP) in 1914. Thus the British Empire obtained an assured source of crude oil, a vital matter, as the Royal Navy was then about to embark (more fully) on conversion from coal burning to oil burning vessels. From 1914 to 1951, the commercial efforts of the company and the diplomatic effort of the Foreign Office, ran broadly in parallel. The Government made two appointees to the Board of BP, but despite this the company always operated as a commercial enterprise. While the company certainly enjoyed a special relationship with the Admiralty, its relationships with the Foreign Office were not dissimilar from those enjoyed between the Foreign Office and Shell, which also played its part in meeting Britain's naval requirements.

According to Anthony Sampson ⁽¹⁴⁾ the Iranian Crisis led to a significant difference of opinion between a substantial body of opinion in the Foreign Office and the Chairman of the Anglo Iranian Oil Company, Sir William Fraser. Sampson quotes John Strachey ⁽¹⁵⁾ as saying that the information at the Government's disposal from inside Iran was scant, and largely obtained from A.I.O.C. sources, which were naturally suspected of bias. Herbert Morrison at the Foreign Office, and E. Shinwell at the Ministry of Defence, egged on by Sir W. Fraser, both favoured intervention. Kenneth Younger, the Minister of State, followed opinion from within the Foreign Office, that opposed intervention, since to work the oilfields was impossible faced with a hostile workforce. Lord Mountbatten with his Indian and S.E. Asian experience, feared that the whole British position in that part of the world would be undermined through intervention. Strachey's own advisors favoured a rapid solution by any means, since they feared that delay would destabilise Iran and lead to a British energy crisis. Strachey, for

his part, was opposed to intervention, and pointed out to his advisors, that neither destabilisation of Iran, nor an energy crisis was likely to result from delay.

A Parachute Brigade was readied for action, and H.M.S. Mauritius was sent to the Persian Gulf. The situation then dragged on throughout the Summer, till Morrison visited Washington to see Harry Truman in September, when the President indicated his firm opposition to British intervention. Notwithstanding the U.S. position, on his return to the U.K., Morrison held to his stance in favour of intervention in the Cabinet Meeting on 27th September 1951, till Attlee firmly terminated the discussion by stating that in the absence of U.S. support, independent action by Britain was quite out of the question. Those members of the Labour Party involved in these events, whether for or against intervention, must have drawn the conclusion, that in the event of a future conflict between the requirements of the Government, and the interests of the company, BP might well prove an inadequate instrument for carrying through Government policy. In the Labour Party at large, suspicion of BP has persisted through to more recent times, fuelled by the experience of the Rhodesian sanctions, so that in 1978 the Labour Party Conference called on the then Labour Government to exercise control over the company, using its shares to this end. As a result of this call by the Labour Party Conference, a committee of Cabinet Ministers was established to consider future relationships between the company and the Government.

With the resolution of the Iranian Crisis (which broadly coincided with the start of a long period of Conservative rule lasting till 1964) relations

between BP and the Government would appear to have reverted to their original condition, so that in 1973, addressing the Public Accounts Committee, Sir Eric Drake the Chairman of BP, described the position of the company in the following terms:

'our policies are normally those of a commercial company and these have been agreed for 60 years or more with Government, and have I think, suited successive Governments. This has never been a controversial matter... we take our decisions commercially without influence from Ministers.'

Within a few months there was to be a conflict between the requirements of the Government and the interests of the company, arising from the 1973 oil crises, the nature of which was indicated earlier, in the statements by Peter Walker and Geoffrey Chandler. Edward Heath seriously considered issuing the company with a direct order requiring it to maintain normal supplies to Great Britain while discriminating against its other customers.⁽¹⁶⁾ This was part of a general attempt to get all the oil companies, particularly BP and Shell, to act in a manner more favourable to Great Britain, and it was collectively resisted by the industry.

On 21st October 1973, Edward Heath called both Frank McFadzean, for Shell, and Sir Eric Drake, for BP to Chequers. In the ensuing talks, some fairly acrimonious discussions took place which were unreported at the time. Mr. Heath pointed out to Sir Eric Drake, that the Government owned half BP⁽¹⁷⁾ but Sir Eric, who had previously taken the precaution of taking legal advice, stated that he was only prepared to discriminate in favour of

the U.K. in response to a direct Order from the British Government, coupled with a clear written instruction of which other countries were to be discriminated against in order to effect compliance. Unless, all the company's customers were treated fairly, then there was a risk that the company's assets might be expropriated in some countries.

Meanwhile, Mr. McFadzean, in separate talks with Lord Carrington, who was assisted by Lord Rothschild, the Head of the Think Tank (a former Director of Shell Research Ltd., brought in to argue the case with his former colleagues) was subjected to the same pressure as Sir Eric Drake, and having co-ordinated his response with that of BP, similarly asked that the Government make entirely clear in writing which other countries Shell would be required to discriminate against. McFadzean argued that discrimination was a function of the Government, a public responsibility, which the oil companies being part of the private sector, and more subject to international pressures, were not prepared to take. He added, that in practice the Majors, in supplying Western Europe in the manner they had, were already taking a considerable risk, for in order to comply with the letter of the Arab embargo, they were making up shortfalls to heavily hit customers, with supplies of Nigerian and Iranian crude oil.

Following these discussions with the representatives of BP and Shell, Heath took advice from the Foreign and Commonwealth Office, and it was their opinion which finally turned the scale, and caused him to abandon his idea of issuing the companies with a direct order. The FCO pointed out that BP was on the very brink of penetrating the U.S. market and developing the vast oil and gas resources of Alaska, both of which events must bring long term

benefits to the U.K. economy. Once the company was seen to be subject to the direction of the U.K. Government, even for the purpose of handling short term difficulties, its independence would be perceived as fatally flawed in U.S. eyes, and in the strongly free enterprise U.S. business environment, the entire BP effort would be at risk.

In the aftermath of these events, the British Government became conscious of its powerlessness, and with respect to the North Sea, felt themselves particularly vulnerable on such issues as the control of depletion rates, and their ability to prevent the re-export of crude oil once landed. Now the Government had long possessed the legal means to do all it required in the North Sea (for example, powers to prevent the re-export of crude oil had existed since 1939) but it now recognised that such legal powers had to be complemented by appropriate organisational means, and thus far, the Labour Party agreed with this general assessment. It was on the choice of the appropriate means that the two Parties differed. The Heath Government believed this end could be secured by establishing a United Kingdom Oil Conservation Authority, a supervisory body, designed along the lines of the Texas Railroad Commission, or the Alberta Energy Resources Board, the Texas State and Alberta Provincial authorities respectively charged with the technical supervision of conservation. These were State/Provincial Authorities in Federal systems, and had not been designed as instruments for the discharge of a wider energy policy. In the event, the Conservative approach was never put to the test, since the Miners Strike and 3 Day Week intervened, causing Edward Heath to call the February 1974 Election, which the Conservatives lost. Thus it was Labour's chosen means to establish greater control over the North Sea, namely the formation of B.N.O.C. (as an

agent for the State to take an interest in existing licences) which was proceeded with. This brought to the fore for the first time in a North Sea context, both ideological and other differences between the two Parties, which revealed themselves in the debate over the formation of the Corporation, to be covered in Para 4.22 (Footnote*).

Footnote* The events of 1973 also had their impact on a far wider stage, through Britain's involvement in the I.E.A. from November 1974. At that time, although Britain had yet to achieve any oil production (but was clearly destined to be a substantial producer) the terms under which she was to contribute to the International Energy Programme were very favourable. Other members were anxious to ensure the involvement of Britain and Norway to the fullest possible extent in the whole range of I.E.A. activities, so that Norway (which was then fully self sufficient) escaped any formal obligations to assist the others through the I.E.P. Britain could not, even if she had chosen to, go it alone at a later date when she achieved oil self sufficiency, for her crude oil from the North Sea was lighter than the Middle East crudes for which her refineries were designed. This necessitated crude swaps of light North Sea crude for heavier varieties, requiring a relationship with countries and companies with access to these supplies. In 1980, with the build up of production and in the second oil price shock, Dafter and Davidson⁽¹⁸⁾ were to argue for a wider use of Britain's oil to secure trade offs in other policy areas from our Western partners.

4.22 The B.N.O.C. Debate; the Differences between the Conservative and Labour Parties In their July 1974 review of energy policy⁽¹⁹⁾ the newly elected Labour Government under Harold Wilson set out the planned objectives for B.N.O.C. as follows:

"majority State participation in existing licences for commercial fields provides the best means for the nation to share fully the benefits of the North Sea. A British National Oil Corporation (B.N.O.C.) will be set up through which the Government will exercise their participation rights. The Corporation will represent the Government in the present consortia... and also build up a powerful and expert supervisory staff which will enable it to play an active part in the future development, exploration and exploitation of the Continental Shelf".

The Labour Party held a fundamental belief in the virtues of State enterprise, and from this arose a favourable attitude to the extension of State participation in the mixed economy. In April 1975, John Smith,⁽²⁰⁾ the Parliamentary Under Secretary of State for Energy set out the case for the Corporation in the following terms:

"First, B.N.O.C. participation in the industry will give the nation a direct right to the oil extracted from our own seabed. Oil underground belongs to the nation, but once extracted it becomes the property of the licensee. Under participation, we shall gain a right in the property and a say in the disposal of our own oil... we shall acquire our own direct knowledge of the different techniques of oil and gas production... in future Licensing Rounds, it will be possible for

B.N.O.C. to be the majority holder and in some cases the sole licensee...we shall gain for this country an independent capability in oil and gas production which will reduce our dependence on international and other oil companies".

Earlier in the Debate, Patrick Jenkin, the Conservative Energy spokesman, with reference to that part of Labour's plan, which involved obtaining a stake in existing licences, stated⁽²¹⁾.

"majority State participation is no more than the ugly unacceptable face of Socialism".

Krapels sets out the arguments used by the two Parties to support these clearly opposed positions, under three headings, as follows:

1. Participation as a way to increase the public share of North Sea Wealth

The Conservative Party used three arguments to counter Labour's contention that a State Oil Company would ultimately increase the public share of North Sea wealth. Firstly, they claimed that the 'dead hand of political control'⁽²²⁾ would affect the oil industry, as was the case they contended with the steel industry and the Post Office. Secondly, B.N.O.C. could not be well staffed as it would not be able to attract staff with employment terms comparable with those on offer from the oil companies. Moreover, public involvement would displace private effort. Finally, Government funds used for North Sea investment, would not be available for use elsewhere, and the new Corporation would not be able

to borrow more cheaply than private industry, or indeed, than the Government itself. The Conservatives principally objected to the Government's insistence that B.N.O.C. participate in existing licences, as well as being the majority holder in future licences, since the imposition of new conditions on existing licences was 'just as much expropriation as the acquisition of property' (23).

In answer these arguments, the Government pointed to the success already achieved in the North Sea by the Gas Council and the National Coal Board, and saw no reason why B.N.O.C. should not emulate this success, or that of its Norwegian counterpart Statoil. It was their intention that B.N.O.C. should work together with the oil companies, not replacing them, but participating with them in the exploitation of the North Sea. As a result of the introduction of B.N.O.C. into the North Sea it was intended that the companies would be 'no better and no worse off' and that there would be 'a continuing and profitable' role for them. (24) Participation in existing licences was to be achieved through 'free and voluntary negotiation' and not by compulsion. (25) The Government pointed out that some companies had asked for participation in existing licences, but omitted to add that these were small companies in financial difficulties, who saw the resulting payments as a way out of their problems. The Majors, responsible for the largest part of existing licences certainly did not welcome the Government's plans to buy an interest in these. Purchasing an interest in existing licences raised two questions, the answers to which will become clear later, in considering the actual development of the Corporation. Firstly, where was the money to be raised to purchase a B.N.O.C. interest in the

existing licences? Secondly, how would the Government and the Corporation proceed, if companies refused to sell some of their existing acreage?

2. Access to Information

In answer to Labour's contention that B.N.O.C. would enable them to acquire more information, and provide for its proper interpretation, the Conservatives agreed there was a need for more information, but argued 'the Government's legitimate objectives would be far better achieved... by setting up a proper, well staffed regulatory agency' (26) and added they were 'much impressed by the trust and confidence in which the Alberta Board was held by the industry, and also... by the confidence of the Board that it in turn was not being bamboozled or misled by industry... the U.K. would do much worse then learn from this experience... instead of saddling industry with B.N.O.C., a huge, unwieldy operating partner'. (27)

In answer to these arguments the Government replied that there was no substitute for participation, since the Tories' proposed regulatory agency would have no right to explore for oil, and so could not acquire the necessary expertise to interpret exploration information. The Government could not hive off decisions of magnitude to a regulatory agency, nor exempt themselves from matters so important as the regulation of the resources off our shores. B.N.O.C. was to be represented in all offshore Operating Committees, not just those for licences where it held an interest, as this was an essential requirement for overseeing

development. (As will be shown when the development of the Corporation is discussed, the presence of B.N.O.C. representation on Operating Committees for licences where they held no interest, was to be a major source of conflict in the years ahead).

3. Participation as a way to enhance Government control over Development

The main weaknesses of North Sea policy, as viewed by Labour were set out by Lord Balogh in the Lords, in April 1975:

'There were no controls over the rate of depletion/production... no adequate provision for the Government to receive financial information from licencees... there was no control over the flaring of gasses from oilwells'

Labour saw B.N.O.C. as an essential part of their strategy to correct this situation, however the Government seriously mixed up the general issue of control with the question of depletion in presenting their case:

'The present controls are totally inadequate... there is no control over the rate of depletion in the national interest... there is no requirement for continuing exploration'. (28)

Thus the Conservatives were able to argue that B.N.O.C.: (29)

'had nothing whatever to do with the controlling of production and depletion...the controls exist entirely independently of B.N.O.C., they bear no relationship whatever to participation. Therefore B.N.O.C. has no role...When the Secretary of State said 'we can have an effective depletion policy on the basis of public participation' he was talking absolute rubbish'.

In addition to these publicly stated positions on the issue, there may have been other considerations which influenced the standpoints of the two Parties. A search of the BBC Programme Library for this period, shows that in broadcasts, the two principle protagonists in the Parliamentary Debate, Eric Varley for the Government and Patrick Jenkin for the Conservatives, stuck close to their positions as stated in Parliament, and nowhere hinted that any other factors lay at the root on their differences, or the lengthy process, still in train, whereby they were coming to grips with complex policy issues.

A special consideration for Labour⁽³⁰⁾ was a concern over a future situation which might arise in the E.E.C. Although a remote prospect, if a European Energy policy were formulated, and there was any likelihood of it being made to stick, then it would be theoretically enforceable against all U.K. companies. Experience suggested that MNOCs might resist a demand for special action from a national Government, but gave grounds for the belief that they would more readily accede to a European Community Directive. In any future crises, such a European Community Directive would most probably place Europe's needs ahead of Britain's special requirements, even to the extent of determining the

disposal of British crude oil. Experience had also shown however, that no Community ruling would be pushed against an interest or company strongly supported by a national Government, since the maintenance of an apparent unity has been more important than strict compliance with a rule. It was Labour's view that if the British interest to be supported against Community pressure was B.N.O.C., then this considerably strengthened the chances of success.

The Conservative Party was publicly committed against the extension of public ownership, so whatever the merits of B.N.O.C., or the form it took they were constrained to oppose the idea of the Corporation. Yet in explaining why the Heath Government had resisted pressure for earlier changes from the Public Accounts, Patrick Jenkin explained that this was due to the need to make a very careful review of options, since it was more important to be right rather than quick. He admitted⁽³¹⁾ that amongst those options carefully considered was State participation, and that this was rejected in favour of fiscal changes, for which it was considered an alternative, because all the best territory had been already licensed, and the Conservatives believed it quite wrong to negotiate an interest in existing licenses, an action which they regarded as little removed from expropriation.

Labour by contrast, had already brought coal, gas and electricity into public ownership, so that the creation of a National Oil Company, while not full nationalization could readily be presented as an extension of that process. The very considerable influence of

Tom Balogh lay behind the policy of forming B.N.O.C. Balogh, an academic colleague of Harold Wilson's from their days together in Oxford, beginning in 1938, had a far greater influence than that due to the fact that he was Anthony Wedgewood Benn's Energy Adviser. Richard Crossman⁽³²⁾ recorded the behind the scenes involvement of Balogh in many matters dealt with by the previous Labour Government up to 1970. In 1973, Balogh had presented his views on the future control of North Sea oil to a hostile audience at the Institute of Petroleum, and these views were incorporated in the 1974 Whitepaper. The Conservatives knew from experience the difficulties associated with denationalization and appreciated that once formed, State enterprises had a way of building up their defences against privatisation by a subsequent Conservative Government. The Banker (1977)⁽³³⁾ observed that full nationalisation to take all North Sea operations under State control was impractical. The proposed Conservative form of regulation was too weak. The creation of B.N.O.C. by Labour, and the subsequent 'negotiation' of a State interest in existing licences, was more appropriate to the state of Oil Company Government relationship.

4.3 B.N.O.C. under Labour The principal matters with which B.N.O.C. was concerned, from its formation, till Labour left office in 1979, were firstly, the establishment of a presence in the North Sea, primarily through the introduction of State participation in existing licences, and secondly, the negotiation of the Britoil Loan. Since success in both these matters was partly attributable to the quality and character of the Corporation's top management team, some appreciation of how the B.N.O.C. Board was constituted, is a necessary preliminary to a consideration of these years under Labour.

The composition of the Board, as set out in B.N.O.C.'s first (1976) Report and accounts is as follows:

Chairman and Chief Executive

Lord Kearton (retired Chief
of Courtaulds)

Deputy Chairman

Lord Balogh

Members:

J. G. Livermore	Deputy Secretary at the Dept. of Energy, i/c Oil and Gas Divs.
L. Airey	Deputy Secretary at the Treasury, i/c Industry Sector.
Lord Briginshaw	Retired senior Trade Union Official
G.H. Laird	Representative of A.U.E.W.
Sir R. Fairbairn	Representative of Clydesdale Bank
C.J. Hearne	Representative of N.M. Rothschild, Merchant Bankers
Sir Dennis Rooke	Chairman of British Gas
R.E. Utiger	Chairman of British Aluminium
I. Clark	Former Chief Executive of the Shetland Islands Council
W.N.A. Camp	Public Relations Consultant, who had worked for Gulf Oil and British Steel.

The above list, contains not a single person with relevant and significant oil industry experience, although Sir Dennis Rooke, had some managerial experience in the North Sea, through the involvement of British Gas in the Consortia which developed the southern North Sea gasfields, and had acquired a reputation as a tough negotiator, in establishing the price paid the oil companies for their gas production. At its formation, B.N.O.C. recruited staff for 'new' jobs, which paid somewhat above their private sector comparisons, since they were not subject to the constraints of the pay guidelines then in force. Despite this, when B.N.O.C. carried out a headhunt for people with relevant oil industry experience, to join the Board, the search proved fruitless. This suggests, that oil industry executives, with

the necessary background, had decided as a group, not to join the Corporation as independent directors. The absence of directors, even in an independent capacity, with oil company backgrounds, reinforced the absence of an oil company view on the Board, which as will be shown shortly, was an intended consequence of denying the oil companies any formal representation on the Board of this new State enterprise, such as that accorded to other concerned interests.

The official reason, which was given for the formal representation of the Department of Energy on the B.N.O.C. Board, was in order to ensure that the new Corporation conformed to the overall guidelines of Government energy policy, but more probably this appointment helped in furthering the close co-ordination between the Department of Energy and the Corporation, which was necessary to bring about State participation in existing licences. The Treasury representatives was there to safeguard the Government's interest in the National Oil Account, into which all Government receipts from North Sea oil were paid, and from which the Corporation was permitted to borrow, as one of its primary sources of finance. The presence of these two Civil Servants on the Board of B.N.O.C. caused some concern in Whitehall, for it was seen as breaching the principle of their being a clear distinction between the formulation and carrying out of policy, and the normal relationships maintained between senior Civil Servants and a Public Enterprise.

Sir D. Allen (Lord Croham) the former Head of the Home Civil Service was appointed part time Deputy Chairman to replace Tom Balogh, when Balogh reached compulsory retirement age in September 1978. Balogh was immediately appointed as a consultant to the Corporation with powers little reduced compared with those he had exercised as Deputy Chairman.

The former Chief Executive of the Shetland Islands Council was Ian R. Clark.⁽³⁴⁾ Mr. Clark was appointed by A. Wedgewood Benn, in view of the remarkable skill he had exercised in negotiating the Sullom Voe terminal agreement with the oil companies, on behalf of the Shetland Islands Council. Clark had piloted a private Bill through Parliament to give the Council full control over this project, costing in all some £500 million. Thereafter, he insisted (for the first time in such agreements) that all the oil and gas brought ashore be stored, treated and liquefied within a single complex. Clark's negotiating position was undoubtedly very strong, since Sullom Voe was unquestionably the best geographical location available for the efficient operation of the terminal. As a trained accountant, he paid great attention to the minutest details which in the past the companies might have regarded as being too marginal for consideration. For example, he insisted on the profitable use of all peat removed in the building process, and secured extra payments for wear and tear on the Shetland Roads, arising from the use of heavy vehicles. Oilmen claimed that his attitude created delays and a mass of paperwork, and attributed his anti industry bias to his membership of the Plymouth Bretheren, but it was his evident ability as a tough operator which appealed to Mr. Benn.

Bailey⁽³⁵⁾ expressed surprise that the oil companies were not represented on the B.N.O.C. Board, and attributes this to the fact that representation on the Board would have compromised the international position of BP, and once BP was excluded, it was necessary to exclude the other companies. It appears more likely that oil company representation was excluded for three other reasons. Firstly, B.N.O.C. had a statutory right to sit on Operating Committees (even where it did not hold an equity interest)

and thus possessed perfect information, which it wished to protect from the oil companies who held only partial information. Secondly, company representation would have contaminated the decision making process with a company point of view. Finally, the representation of the Department of Energy shows that the Government proposed that the Corporation should work closely with the Department of Energy, and that this relationship took precedence over any relationship with the oil companies. Thus the original constitution of the B.N.O.C. Board was designed to facilitate a tight control over North Sea decisions, by the Department of Energy, the formal regulatory authority, acting in close concert with the British National Oil Corporation.

The process of securing a B.N.O.C. presence in the North Sea, involved two factors. The first factor involved the takeover of some existing interests held by the National Coal Board and the acquisition of a substantial part of the North Sea holdings of Burmah Oil. These matters will be briefly described before considering in detail the second factor involved in securing a B.N.O.C. presence in the North Sea, the more interesting process (politically) whereby 'voluntary agreement' was reached for B.N.O.C. to buy into existing licences.

As regards the takeover of existing interests, under the Petroleum and Submarine Pipelines Act 1975, B.N.O.C. acquired the offshore assets of the National Coal Board, by purchasing them at face value from NCB (Exploration) Ltd. B.N.O.C. also took over certain long term obligations of the NCB relating to its North Sea activities, and discharged these with an advance of £90 million from the Government. In 1976, Burmah Oil got into serious financial difficulties, and both the Government and the Bank of England were

involved in resolving its problem. As a result, B.N.O.C. acquired 80% of the interests of Burmah Oil (North Sea) Ltd., which itself included 80% of the Ninian Field. To manage these interests, a new B.N.O.C. subsidiary, B.N.O.C. Ninian was formed. The remaining Burmah North Sea interests, in Burmah Oil Development, a company responsible for Burmah's North Sea staff, and for its activities within the Operating Agreements, was similarly purchased by B.N.O.C. and renamed BODL Ltd. The total cost of these purchases was £130 million, for which the Corporation obtained, as a compensation for substantial interest payments, a substantial North Sea acreage, together with the specialist staff needed to support operations. As a result of the BODL acquisition, B.N.O.C. obtained the following equity: Thistle field (16.2%); Murchison field (33%); Viking Gas field (50%).

The process of obtaining 'voluntary agreement' for B.N.O.C. to buy into existing licences, so that the companies were 'neither better nor worse off' involved agreements falling into 3 groups:

- (1) Agreements with Smaller Companies Companies such as Tricentrol, Ranger and Conoco fairly readily agreed to sell 51% of their crude oil to B.N.O.C. at market price.
- (2) Agreements with Shell/Esso and other Majors These companies agreed to sell their crude oil to B.N.O.C. at the market price, and then to buy it back from the Corporation to meet the needs of their refineries. In later years, a further element was introduced, which enabled the companies to swap heavier crude oils from elsewhere for lighter B.N.O.C. crudes.

- (3) Agreement with BP Same as (2) except that BP agreed to train B.N.O.C. staff in Downstream activities, subject to an agreement that B.N.O.C. would not go Downstream (into marketing and refining) for 5 years.

As regards (1) above, these smaller companies did not have their own refineries in the U.K., so that in conditions of refinery overcapacity then prevailing they were pleased that sale of their crude oil to B.N.O.C. gave them a guaranteed outlet. As regards (2) negotiations were particularly protracted, especially with Shell/Esso, who work together in the North Sea, with Shell as the operator. Strong language was used by the companies in stating their objections to B.N.O.C. proposals. For example, Clifton Garvin Jnr. of Exxon (Esso) stated ⁽³⁶⁾ 'as long as these agreements are voluntary, we are not volunteering'. What lay behind these protracted negotiations has been explained by Austin W. Pearce ⁽³⁷⁾ Chief Executive of Esso Petroleum Co. Ltd., Exxon's U.K. subsidiary. Before Shell/Esso would agree, they had to be sure that they would be permitted to buy back sufficient of their North Sea crude to service their U.K. refineries, which took 2/3 of this production. However, at the outset of the negotiations, B.N.O.C. were only considering allowing the companies to buy back enough crude oil to meet 1/3 of their requirements. The resulting buy back agreements, which met the companies' requirements were regarded as something of a farce at the time, but they did establish B.N.O.C. ownership of crude oil, which meant that in the event of a dispute it would be the companies who would have to seek redress from the Courts. The Agreements were based on B.N.O.C. ownership of the crude oil in return for continued company access to the same crude oil, which in the circumstances of refinery overcapacity,

suited all parties. The subsequent introduction of crude oil swaps into the arrangements, enabled the lighter North Sea crudes to be exchanged for heavier Middle East crudes, for which the U.K. refineries had been designed. The companies had some long term fears as to how and when B.N.O.C. would itself move into Downstream activities, but given the 30-40% refinery overcapacity then prevailing, and the likelihood that this would continue, the most probable scenario would be for B.N.O.C. to become engaged in special projects for 'whitening the barrel' (techniques concerned with increasing the quantity of gasoline obtained from crude oil).

During the Corporation's first year of operation, stated it's intention to act commercially yet amongst its staff there were those who saw the function of the organization to be supporting the watchdog activities of the Department of Energy, the official regulatory authority. For the Labour Party at large, the existence of the Corporation, and in particular the target of 51% participation, were symbols of political achievement. As for the oil industry, it feared that the Corporation would act as a ruthless entrepreneur, taking full advantage of all its special opportunities, so as to compete unfairly with the private sector.

With the 5th Licensing Round, the companies' fears appeared to be justified, for Amoco which had held out against 'voluntary' agreement on retrospective participation in existing licences, received no acreage under the discriminatory system of licence allocation. At the same time, a rift appeared between the Corporation and the U.K. Offshore Operators Association. Since B.N.O.C. was now to have a statutory interest in all the new Blocks allocated, both the Association and the Corporation realised that this would

involve agreements being reached between the Corporation and each of its many partners, and so agreed to prepare and exchange proposed standard drafts for such agreements. The U.K. Offshore Operators Association rejected the Corporation's draft, the background to this rejection being as follows. The Offshore Operators expected that the Corporation would act commercially, which meant that it would act behind the back of its private partners in its own interest. Because of this, the Offshore Operators included in their draft agreement, a clause normal in such Operating Agreements up till that date, to the effect that each partner undertakes not to apply on its own account for Blocks surrounding the Block covered by the agreement in question. Since all partners in a Block subject to a collective agreement would have invested money in the exploitation of the Block, it would be unfair if one of the partners made an individual fresh investment on the basis of information secured by all the partners as a consequence of collective expenditure. Now B.N.O.C. would soon have far better information than any of its private sector partners and like its sister organization British Gas, it was permitted unlike the private sector companies, to apply for Blocks between Licensing Rounds. For these reasons, the B.N.O.C. excluded the conventional clause which would have placed a limitation upon its statutory rights.

Similar fears existed in the oil companies over the question of relinquishment. Under the licensing arrangements, continued control over a Licence Block was subject to the performance of an adequate Work Programme, and failure to carry through such a programme led to relinquishment. However, the authority which judged whether a Work Programme was satisfactory

was the Department of Energy, and what was to stop the B.N.O.C., which was working closely with the DOE, from exerting pressure to have a Work Programme declared unsatisfactory, in order itself to take over a promising prospect? Furthermore, if B.N.O.C. was part of two Consortia, both bidding for the same Block, then it would require the judgement of King Solomon, to decide upon the merits of each bid, and decide between them. Many of these matters were not readily resolved, and as the Corporation moved to build up its staff, delays occurred in the North Sea decision making process, even where these delays were not the result of Department of Energy action designed to create special advantages for the new Corporation.

By early 1978, many of the oil companies and their executives were becoming extremely depressed by the impact of B.N.O.C. upon the North Sea, although the companies themselves did not complain for they feared to rock the boat, as this might set off further moves against them in the shape of granting B.N.O.C. the first refusal on farm ins (sales of equity to secure fresh working capital), and the granting of B.N.O.C. sole rights in the ownership of Blocks. In short, a further shift of advantage away from the oil companies, and towards the Corporation, appeared to be in the pipeline. This did not prevent some individuals expressing their views, and indeed these private expressions of view may have been sponsored by the oil companies, in the sure knowledge that they could disclaim responsibility if the going got rough. The first public complaint came from George Keller of Standard of California,⁽³⁸⁾ and it came in a David Frost interview by satellite, on 4th April 1978. Standard of California's subsidiary Chevron, was the Operator of the Ninian field, in which it will be recalled, B.N.O.C. held a substantial interest, through its acquisition of the former Burmah Oil

holding.

George Keller said 'B.N.O.C. makes no contribution to your economy, or your control of the oil situation, and it does slow down and complicate out attempts to run a very professional business. I can think of nothing which has been accomplished so far which couldn't have been accomplished faster, at a lower cost, if there had been no B.N.O.C.' and he added that the Corporation was an 'albatross around the neck of the oil industry'. In reply, Lord Kearton stated that 'the organization, ideas, and motivation to place orders in the U.K. were all inadequate' and 'B.N.O.C. holding 21% of North Sea equity, was in a strong position to see the thing done properly,' adding that 'the albatross was a good luck bird, and the trouble in the Ancient Mariner is they shot the good luck bird.' Immediately after the programme, Lord Kearton obtained a public retraction of the Keller statement from Standard of California.

On the day following the programme, B.N.O.C. announced that the Thistle field was in production, and Anthony Wedgewood Benn made a significant statement about the Corporation, to the effect that B.N.O.C. had been granted exclusive control of a number of licence Blocks, and that B.N.O.C., and to a lesser extent British Gas, had been given first refusal on all assignments (changes of ownership, including 'farm ins') for territory allocated in the 1st to 4th Licensing Rounds. Mr. Benn announced a particular 'farm in' deal between B.N.O.C. on the one hand and the original licensees, Chevron, Siebens Oil and Gas U.K., and Westburne Drilling Co. The Benn announcement, suggests the real cause of the Keller outburst, but also indicated that relations between Standard of California and the British Government had not been

seriously impaired. Mr. Benn stated 'Chevron will carry B.N.O.C. for all costs until a discovery is declared commercial, and a decision is taken to develop by the partners. At this time, B.N.O.C. must decide whether or not to proceed with its interest, and pay its share of past and future costs'. Keller's reference to the slowing down and complicating of the decision making process, related specially to the annoyance caused by the manner in which this particular deal had been handled by B.N.O.C. and the Government, for Chevron, Siebens and Westburne, had themselves agreed an arrangement in the Summer of 1977, whereby they had hoped to see their drilling ship Ocean Lancer at work in the territory in question by August of that same year. However, such arrangements were subject to the approval of the official regulatory authority, the Department of Energy, and there was a strong suspicion on the part of Standard of California, which had indeed existed for some time before the Frost interview, that approval of the deal between the original licensees was being purposefully delayed, till such time as procedures for the preferential inclusion of B.N.O.C. had been completed. Events suggested the suspicions of Standard of California to be well founded.

A similar incident occurred in the relationship between Occidental Petroleum and the Corporation, when Robert McAlister of Occidental prepared a letter for his company's House Journal, in which he claimed 'the unpublished objective of the Socialists is eventually to put the rest of us out of business in the U.K.' Like the unpublished objective, this letter was never itself published, and the author thought better of it, but it was leaked. The letter as leaked, claimed that B.N.O.C. had influenced the Department of Energy, so as to delay the 5th Licensing Round for over a year, till such time as the Corporation was in a better condition to bid for acreage, and

take full advantage of all the opportunities created for it by the Government. As for Occidental itself, approval for its drilling on Block 14/18 had been held up for a further 3 months, so that B.N.O.C. might exercise its option to become involved. Lord Kearton obtained a public retraction of the view expressed in the leak from Armand Hammer, McAlister's superior.

The U.K. Offshore Operators Association attempted to get the provisions granting B.N.O.C. the first refusal on relinquishments repealed, but this pressure was not successful. The powerful position established by B.N.O.C. in the North Sea, caused Tom King, the Conservative energy spokesman to refer to the 'Godfatherlike power of B.N.O.C.' Lord Kearton dismissed all criticisms both from the oil industry and the Opposition, observing that 'the Government has been extraordinarily scrupulous in living up to the pledges it gave to the oil industry.' B.N.O.C. spokesman claimed the 'unpublished objective' was 'way off beam' and further stated that the reason behind the slowing down of North Sea decisions, related to concern over depletion, which in the light of the circumstances hardly rings true. The journal Industry Week⁽³⁹⁾ asked the question, why is B.N.O.C. able to exercise such power? The conclusion it reached was, that under Benn and Kearton, the roles of the Department of Energy and the B.N.O.C. had become blurred, so that every project in the North Sea, be it a multi million pound project, or a relatively small matter, had to pass through both organisations before a decision could be taken. The article quoted an unnamed Operations Manager as saying 'if they want to get you, they can make life hell, they can delay a multi million dollar project, and they do if it suits them'. The company voice expressing itself here was now anonymous, but it was clear that the

companies felt the delays to be intentional. At one point in the argument between the oil industry and the Corporation, Lord Kearton had said the intention of a mass of irrelevant complaints was merely to arouse the press, and to stimulate Opposition politicians, rather in the fashion of old fashioned lawyers who bring up a mass of irrelevant matters to influence a Jury. Now it was clear that the oil industry felt its grievances to be well founded.

In announcing the 6th Licensing Round, Anthony Wedgewood Benn, claimed that the terms were now tougher, in order to compensate the Government for the fact that the terms in previous Rounds had been so advantageous to the oil industry. In June 1978, the U.K. Offshore Operators Association sent a delegation to the Department of Energy, to complain that the Government's North Sea policy was now so obstructionist, that the whole North Sea programme was in danger of getting bogged down. The Association objected, on behalf of its members, to plans designed to give both the best Licence Blocks, and over 51% of the equity, to B.N.O.C., as well as the proposal that the private sector oil companies would cover B.N.O.C. for all its costs till such time as a commercial discovery was located. Then, as part of their bargaining strategy, they threatened to boycott the 6th Licensing Round entirely, unless there was some improvement in the situation.

Earlier in the same year (1978, Lord Kearton, speaking to the Select Committee on the Nationalized Industries, gave a hint that perhaps he too feared the balance of advantage in the North Sea had shifted rather too much in the Corporation's favour, by expressing the view that the best days in the North Sea were over, and he believed there might be 'a retreat to home

waters' by the U.S. oil companies, in order to concentrate on the development of their domestic oil resources. A shift of effort away from the North Sea, could of course be a reflection of the relative unattractiveness of the North Sea as compared with elsewhere, rather than as Lord Kearton stated, the pressure to develop domestic U.S. oil resources, reflecting the progressive trend away from a state of self sufficiency in the U.S.A. While almost all production estimates in the North Sea tend to be high initially, and require subsequent adjustment downwards, the year 1978 was remarkable in this respect. Initial estimates, suggested production would lay between 60 and 70 million tonnes, but these were sharply reduced to 55 million tonnes during the year. Thus it does appear that the bureaucratic delays of which the oil industry complained, and the reduced attractiveness of the North Sea, arising in part from these delays and stiffened terms, were having a practical toll. Thus the Government, in seeking to change the business environment in the North Sea at so rapid a rate in favour of B.N.O.C., had held up decisions till such time as the Corporation was ready to take advantage of each change in its favour, and the resulting situation had proved a general disincentive to the oil industry.

Throughout this period, there was no serious conflict between the dual roles of the Corporation as a State enterprise and a commercial company, as the energies of both the Corporation and the Government were jointly directed to building up both the capabilities and responsibilities of B.N.O.C. The general accord between Anthony Wedgewood Benn and Lord Kearton on securing these objectives, was maintained without any serious breach, even though Kearton did object to the Government's decision to build an extra Drilling Rig on the Clyde as a measure of support for the Shipyards, when in his view

there was no commercial justification for the vessel. A greater possibility existed for conflict between the Government and the Corporation once the period of initial buildup was completed, or where the Government was ideologically opposed to State enterprise.

In June 1977, B.N.O.C. took advantage of its powers to borrow privately, and negotiated the Britoil Loan in the U.S.A., the advantage of which included a limited measure of protection against any attempt by a future Conservative Administration to reduce the Corporation's powers, through the privatisation of this recently acquired North Sea assets. The Corporation engaged in a defensive strategy⁽⁴⁰⁾. At the time of the Britoil Loan, which was not guaranteed by the Treasury, the Corporation had borrowed £900 million of U.K. Government funds from the National Oil Account, out of a total permitted borrowing of £1500 million, and was paying interest at 14.1% at a time when U.K. industry was borrowing money at 8%. The Britoil Loan, negotiated with a consortium of primarily American Banks (Barclays, Chase Manhattan, Chemical Bank, Citibank, Continental Illinois, Manufacturers Hanover Trust, Republic National Bank of Dallas) also involved repayment at 8% of a loan of £825 million, which was secured against the forward sales of B.N.O.C. crude oil by an organisation called Britoil, which was set up in the U.S.A. for the purpose, and gave its name to the agreement. Repayment started in the 3rd Quarter of 1978, with funds obtained by this means, and the Loan lasted for 8 years, so that any Government move which might seriously undermine the flow of crude oil to fund this repayment, would lead to an instant demand from the banks for the total repayment of the capital sum. At the time of the Britoil Loan, estimates of North Sea production for 1980, lay between 90 and 100 million tonnes, and of this, 60% was B.N.O.C.

crude oil. For purposes of comparison, in 1976, BP total sales of crude oil totalled 79 million tonnes, and of refined products, 86 million tonnes.

In June 1977, the Britoil Loan was viewed in business circles in terms of the status it provided for the Corporation, for the acquisition of such a Loan signalled to the international business community, especially the Americans, that B.N.O.C. was a viable enterprise, and distinct from such lame ducks as British Leyland and British Steel. In short, the Corporation was in the Big League of oil companies. Secondly, as the loan was with a primarily U.S. consortium, it was in this sense doubly out of Parliamentary control, being both a private loan, and an arrangement made with non British interests. It gave the Corporation a measure of protection against a Conservative remodelling of its role. Not a total protection of course but some safeguard against a programme of radical change, both as to the extent of the changes the Conservatives might contemplate, and the rate at which these might be introduced. Thirdly, by borrowing at 8% the Corporation was able to repay many of its outstanding commitment to the National oil Account, the interest to which was then running at 14.1%. The Corporation knew, that when a Conservative Government again took Office, there would be a reassessment of the role of State Corporations, and in view of the publicly stated attitude of the Conservative Party, it seemed most likely that B.N.O.C. would be a prime target for the reduction of its role. The Britoil Loan, while being sound commercially, provided some defense against this eventuality. Towards the end of Labour's period of Government, Douglas Evans (41) observed 'B.N.O.C. seems to personify both in Statute and in practice all those elements of interventionism which have characterised the post war history of Britain under both Conservative and Labour Governments, which we

are now being obliged to re-examine. The solution may not be so drastic as a wholesale abolition of bodies like B.N.O.C., but more probably a willingness to fail to fully implement its truly enormous powers, and to restrict its activities very largely to Upstream Operations'.

In view of the criticisms made of B.N.O.C. during this period, it may be of value to consider how the Corporation judged itself, at the end of Labour's period of Office, as a benchmark against which to set the view it expressed of itself during the ensuing period of Conservative Government. The Corporation's 3rd (1978) Report and Accounts,⁽⁴²⁾ was published on 3rd April, 1979, and after a factual statement of the work carried out during the period covered, pages 6-7 are concerned to justify the special role accorded B.N.O.C. by arguing the case for the Corporation on four grounds. Firstly, B.N.O.C. provided increasing knowledge and understanding of North Sea activities; secondly, B.N.O.C. provided a knowledge of technology, thus helping safe and economic development; thirdly, the Corporation contributed to the dialogue between the oil industry and the Government; finally, the Corporation advised the Government on the development of national oil policy. The Report then set out to clear up what it claimed, were two common misconceptions about B.N.C.O., namely that it enjoyed special financial advantages compared with private industry, and exercised a high degree of control over North Sea activity, which was detrimental to the progress of the work.

On the financial charge, the Corporation agreed that unlike the oil companies, it did not have to pay PRT (Petroleum Revenue Tax), yet since all PRT payments had to be made into the National Oil Account, into which all

B.N.O.C. receipts had anyway to be paid, what would be the point? The impact of making PRT payments, had they been made, was actually shown in the Corporation's Accounts, though it is well to remember that if the Corporation had been given such a liability, no actual payments would have been due till 1983. The Corporation pointed out that it had not been involved in what it termed the early bonanza (this was an echo of Anthony Wedgewood Benn's argument in favour of stiffer terms for the oil industry in the 6th Round, because they had benefited from former very favourable conditions), and further pointed out that the Corporation had financed a substantial drilling programme, at a time when discovery rates were falling. The whole B.N.O.C. programme of activity, had required the Corporation to carry massive interest charges, on debts incurred over a very few years, and the payment of £115 million to Burmah Oil, had been for assets valued at well above historic costs, at the time of purchase. Despite these financial disadvantages, the Corporation was hopeful of achieving a profit in 1979.

On the charge that it exercised a high degree of control over North Sea activity, which was detrimental to the progress of the work, the Report contented itself with stating the formal position on the regulation of North Sea activity, which was that the Corporation was not the regulatory authority, and that the duty of securing regulation lay with the Department of Energy. While one does not expect a sophisticated response to such a charge in an Annual Report, which after all is a fairly straightforward document for public relations purposes, this response fell short of what was required, in that it totally failed to answer the real charge of the Corporation's critics, namely that under Kearton and Benn, the formal lines of demarcation between the responsibilities of the Corporation, and those of

the Department of Energy, had become blurred. The Report went on to point out that while the Corporation had a duty to advise the Government, the Government was under no obligation to accept this advice. Once again, in stating the formal position, no answer was made to the charge of the Corporation's critics, that the roles and responsibilities of the Corporation and the Department of Energy had become blurred.

4.4 B.N.O.C. under the Conservatives In October, 1978, a report by the U.K. Offshore Operators Association observed:⁽⁴³⁾

'a mammoth effort will be needed... to achieve substantial production levels in the 1990's. This will call for extensive involvement of the whole international oil industry. Therefore U.K.O.O.A. strongly advocates that the Government, in defining its policies... should concentrate on providing the necessary incentives... it suggests the controls the Government have built up over the rates of production .. are more than adequate, so that new Government planning effort should be switched from controls to incentives.'

In the previous year (1977) a statement of Conservative economic policy appeared,⁽⁴⁴⁾ one of the authors of which was David Howell, who took over the Department of Energy when the Conservatives came to power in 1979. A brief reference was made to a whole range of economic and industrial issues, and notwithstanding a vagueness, which is a general characteristic of all such policy statements, it remains surprising that no reference was made to B.N.O.C. or its role in the North Sea, given the Conservatives' so recently fierce opposition to the Corporation's creation. Nevertheless, the general

philosophy behind this policy statement, reflected in its stress on the need to reduce controls, and increase incentives, appeared to be substantially in accord with the strategy advocated by the U.K. Offshore Operators Association.

Bailey,⁽⁴⁵⁾ provides a useful survey of the first 6 months of the Conservative Government, in respect of decisions effecting B.N.O.C. and the North Sea. After a review of the Corporation's role, David Howell made a statement of the Government's intentions on 26th July, 1979. The objective was to reduce the powers of B.N.O.C. in the following manner. Preferential access to the best North Sea acreage in the allocation of licenses was to be removed from B.N.O.C. The Corporation was to lose its right to seats on Operating Committees in those cases where it did not hold equity, and was no longer to enjoy the right to borrow from the National Oil Account. The role of B.N.O.C. as adviser to the Government on North Sea policy was to be ended. The effect of these measures would be to remove any unfair advantages B.N.O.C. possessed, compared with the Private Sector, to stress the Corporation's commercial role, and eliminate its function as the Government's North Sea watchdog, where its activities were regarded by the oil companies as an unwarranted intrusion into their legitimate concerns.

Having thus made clear the Government's intention to eliminate B.N.O.C.'s role in the control of North Sea activities, David Howell went on to say that the Government proposed to raise £400 million through a sale of B.N.O.C. assets, so as to bring private capital into the North Sea. The Corporation was the largest trader of North Sea crude oil, and these trading operations were bringing in a revenue of £300 million a month. While there was no

suggestion at this time that the Government planned to interfere in this trading role directly, in Sir Geoffrey Howell's earlier June 1979 Budget, the Corporation had been made subject to Petroleum Revenue Tax (PRT), the terms for the application of which had been sharply stiffened. The effect of these measures was to highlight and separate the two roles of the Corporation, an Upstream Exploration and Production role, and a Downstream Trading role, so that Bailey wondered at the time whether the real intention of the Government was not to divide B.N.O.C. into two separate organisations to carry out these tasks.

On September 14th 1979, David Howell, in a move described by Richard Bailey as 'an elegant three point turn' announced that the sale of £400 million of B.N.O.C. assets, was postponed indefinitely. This raised the issue of what caused the Government to change direction, and was this change of direction a temporary deviation, after which they would return to their former course? Howell explained that the Government were now considering the introduction of North Sea bonds which would enable the public to share directly in North Sea wealth, an intention which Sir Geoffrey Howell was to reiterate in 1981. The 1979 decision to put the sale of B.N.O.C. assets on ice was only taken after a very long discussion in Cabinet, (46) and in his statement David Howell indicated that the Government now proposed to obtain the money they required from the forward selling of crude oil, an operation in which B.N.O.C. was well skilled as a consequence of its Britoil operations. Reference to the need for money, indicated that this was the immediate consideration involved in the proposed sale of assets, rather than a fundamental desire to introduce more private capital into the North Sea.

Lord Kearton, who planned to retire in November 1979 as B.N.O.C. Chairman, a move he intended to carry through even before the new Conservative Government took Office, mounted a campaign to convince the Conservative Ministers that a massive sale of assets would be ill judged. He based his argument not only on his experience with B.N.O.C., but also as a result of his Private Sector experience. It was he who used the argument for the first time, which was to become the standard defence by a successful State industry, threatened by the prospect of vertical divestiture and privatisation. Just like a private Sector company, a successful State enterprise depended for its continuing success upon a stream of profits which were generated by its profit making assets, and a Government committed to the generation of profit making enterprise must surely recognise the truth of this proposition. A sale of B.N.O.C. assets on the scale intended, would undermine the Corporation's profit making base, undermining its hopes of becoming fully profitable in 1979, and endangering the basis of the Britoil Loan. The Government both wished to reduce taxation, while increasing its income and avoiding an increase in their Public Sector Borrowing Requirement, and on balance a large scale sale of B.N.O.C. equity, requiring a major renegotiation of the Participation Agreements, was incompatible with this aim. A judicious sale of equity (by means of small 'farm ins') was practical, as the detrimental effects of a large scale sale would be avoided, and since B.N.O.C. was experienced in the forward selling of crude oil, some additional crude might be sold in this fashion to meet the Government's current financial difficulties. Immediate and large scale privatisation was not achievable, and such privatisation, to be a valid option, would need to be spread over a longer period. Baily suggests these arguments of Kearton's led to the 'elegant three point turn, and he finds it surprising that a

Conservative Government, imbued with the enterprise ethic, did not themselves appreciate the stream of profits argument, and had to wait for Kearton to point it out to them.

In February, 1981 the Petroleum and Continental Shelf Bill was published, and although it subsequently had to be reintroduced, and was not enacted till mid 1982, its initial appearance, suggested that the Government had returned to their former tack. The Bill contained the following powers. B.N.O.C. (in effect the Secretary of State) was empowered to sell its equity, to hive off some of its activities (unspecified) into subsidiaries, and to offer shares in these subsidiaries to the public. Proceeds from all such sales were to go into the Consolidated Fund, and the National Oil Account was to be abolished.

According to the The Economist,⁽⁴⁷⁾ the reasoning behind this fresh determination to privatise, could be traced to a fresh look being taken at the relationships between the Government and State industry, recently carried out by Ron Tibbs of the Central Policy Research Unit. This study demonstrated that the forward financial estimates of State industries for 1981, were already hopelessly innaccurate, even very early in the year, and suggested that the Government needed to review means of losing some of the resultant liabilities, and cushioning their effects. Arising from this study, and concurrently with the publication of the Petroleum and Continental Shelf Bill, attempts began to get British Gas to dispose of its successful Morecambe Bay gasfield, to sell off the oilfield it had discovered at Wytech Bay, Dorset, and to divest itself of its High Street gas appliance business.

Significantly, towards the end of 1981, (which is the concluding date for the present study), David Howell was replaced by Nigel Lawson, who announced on 18th October 1981, that the Upstream (Exploration and Production) activities of B.N.O.C. would definitely be privatised, less a small retained stake, while the offshore operations of British Gas would receive similar treatment. Norman Lamont, in answer to a question from David Owen, stated that all the privatisation decisions had been taken before David Howell left Office, but the fact remains that Nigel Lawson was of a more determinedly monetarist and Thatcherite view than his predecessor, which suggested to the writer that on this occasion, the change of policy was likely to be persisted with, and there was no reason to conclude that the Conservatives now accepted that the stream of profits argument applied to successful State enterprise, in the same way that Labour accepted the contribution of a successful Private Sector to the mixed economy. The need to bail out 'lame duck' State enterprise with a minimum of impact upon the Treasury, appeared to make the disposal of profitable State enterprises attractive in the short term, whatever the longer term results for the Exchequer. (Footnote*)

Footnote* A survey made in April 1983, (48) shows how Nigel Lawson actually proceeded. B.N.O.C.'s trading arm was retained, with access to 51% of North Sea crude oil, while B.N.O.C.'s Upstream (Exploration and Production) activities were hived off into a new company, Britoil, headed by Philip Shelbourne. An underwriting exercise was carried out by the Banks and Pension Funds in November, 1982, and 51% of the new company was offered to the Public in April 1983, whereupon only a third of the offer was taken up, principally by small investors, as a consequence of the depressed condition

of oil shares at that time. When Britoil was established, B.N.O.C. had £252 million of debts which were transferred to the new company. In addition to this, B.N.O.C. owed the Government a further £129 million, which was recovered by means of a £132 Million debenture, which sum then added to the company's initial balance, to give it a total debt of £384 million. By this means, Lawson was able to demonstrate to the House of Commons that there had been no cancellation of debt, which would have been a cause for additional outrage from the Opposition, given the sensitivity to the denationalization issue on their part. Labour committed itself to the renationalization of Britoil on terms which would deprive investors of any capital gains. As regards the plans to make British Gas sell off their Wytch Farm, Dorset oilfield, the local Isle of Purkbeck newspapers, show that in late August 1983, British Gas were still fighting a rearguard action, by disputing to the last the financial terms for this sell off of their assets, on the grounds that the oilfield has now achieved a very substantial production. The final sale of Wytch Farm was completed in May 1984, to a Consortium of interests, by which time plans were well advanced to sell the North Sea oil interests of British Gas to the public by floating a new company called Enterprise Oil.

(End of Footnote)

It remains to be considered how the Corporation and the oil industry reacted to the change of Government, and the subsequent modifications of policy, from 1979 to 1981: The response of the Corporation can be seen from the 1979 and 1980 Reports and Accounts. The 1979 Report (47) contains some significant remarks by R.E. Utiger, who had succeeded Lord Kearnton as Chairman:

'It has been the essence of (B.N.O.C.'s) activities throughout its existence that it must aim for the highest degree of efficiency in its operations; that it would work in partnership with private sector companies; and that, as the national company it would be particularly responsive to national policy objectives. The Corporation believes that it can carry out a valuable role for the country, under widely different political regimes.'

At a later point, in the Highlights, the Report shows how the Corporation had proceeded towards the objective of a judicious sale of equity:

'The Corporation advertised that it was willing to consider offers from companies to 'farm in' 23 of its licensed Blocks. Negotiations on a number of these were in progress at the end of the year.'

In the 1980 Report ⁽⁵⁰⁾ Philip Shelbourne, who had by that time taken over as Chairman and Chief Executive, stated:

'The Secretary of State made a significant speech in October 1980, concerning the future of the Corporation, and these proposals are incorporated in the Petroleum and Continental Shelf Bill introduced in February, 1981. While pressure on the legislative timetable, makes it unlikely that further progress on the Bill will be made in the current Parliamentary Session, the Government has confirmed that it remains committed to the Bill, and that it intends to reintroduce it in its present form, during the next Session.'

As regards those changes already introduced by the Conservative Government, shortly after they came to Office, he observed:

'These undoubtedly had a beneficial effect on our relations with the oil industry generally, as it no longer felt that we occupy and unduly privileged position.'

Amongst the Highlights listed in the 1980 Report, it is noted that several of the Corporation's senior staff are assisting the exploration arm of Petronas, the Malaysian National Oil Company, and that Petronas staff are training with the Corporation in the U.K. B.N.O.C. was also carrying out joint training programmes with the Venezuelan National Oil Company, and was actively negotiating for onshore and offshore acreage in Dubai. Since all such moves abroad were at the discretion of the Secretary of State, this indicates that the Government was encouraging the process of multinationalisation, probably as part of a strategy designed to make B.N.O.C. more like a Multinational Oil Company. However, most of B.N.O.C.'s overseas connections were with other National Oil Companies, and not with the Private Sector. Moreover, the changes in hand, to privatise the Upstream (Exploration and Production) arm of B.N.O.C., were to ensure that neither the privatised Britoil, or the remaining activities of B.N.O.C. in the trading area were like MNOCs, since both were the outcome of vertical divestiture, while an MNOC tends to be vertically integrated, in all phases of the business.

In the 1981 Report ⁽⁵¹⁾ Shelbourne spoke of privatisation in the following terms:

'The effect...will be largely as set out in my last Statement, namely the abolition of the National Oil Account, and the transfer of our present Upstream activities of exploring for and getting oil to a new subsidiary called Britoil. At the earliest appropriate date, 51% of the ordinary shares of that company will be sold to the public'.

R.E. Utiger's Chairman's statement, retains an element of justification for B.N.O.C.'s existence, rather in the style of his predecessor Lord Kearton, but Philip Shelbourne's is merely factual, noting the proposed changes.

The response of the oil industry to the changes introduced by the Conservatives when first they came to Office, and the forward selling of crude by B.N.O.C. to assist the Government with their immediate financial problem, thus avoiding the need for a large scale disposal of assets, were varied. The normal practice with the forward selling of crude oil, is for the money to change hands at the time the crude oil is delivered, the price having been determined at the earlier date of contract. However, in late 1979, B.N.O.C. required that U.S. companies purchasing North Sea crude oil should pay cash at the time of contract. ⁽⁵²⁾ Some 6 U.S. companies were required to pay cash 'up front' in this manner.

In the North Sea itself, those U.S. Independents without U.K. refining capacity, who had been happy to enter Participation Agreements, in order to

secure a certain outlet for their crude oil at a time of refinery overcapacity, by 1980 were complaining that they were not receiving a fair price for this crude oil from B.N.O.C. A more general dissatisfaction was expressed by the oil industry, as a result of the delays experienced in carrying forward the 7th Licencing Round. These delays arose from the time needed by the Government to carry through legislative measures to reduce the powers of B.N.O.C., which action was a prerequisite of the 7th Licensing Round. Barbara Ellis ⁽⁵³⁾ however, suggested that the 7th Licensing Round was having the effect of encouraging the oil companies, not just the Majors, to return to the North Sea, since the provisions of the Round required that the larger companies and B.N.O.C. should become associated with the smaller companies in joint licence applications. At the end of our period, the very limited evidence available suggested a greater interest in the North Sea by the oil industry, in part resulting from the reduced powers of B.N.O.C.

4.5 Summary of Conclusions

Multinational Oil Companies (MNOCs) operate on the principle of global optimisation, which has generally brought many economic benefits for countries involved in the system, but where the results of global optimisation are economically sub optimal for a particular country, this provides grounds for the formation of a National Oil Company (NOC). However, the grounds for setting up National Oil Companies (NOCs), have usually been other than economic, so that when National Oil Companies (NOCs) are set up, this creates a potential for a conflict between commercial objectives of the professional managers, who take entrepreneurial advantage of all the special support given them by

their Governments, and the social and political objectives of those Governments. (Para 4.11)

The 1973 Oil Crisis, demonstrated the increasing power of all the producing countries, not just the Arab States, and encouraged a speeding up of the process creeping nationalization, through an extension of the roles assigned to their National Oil Companies (NOCs). Concurrently, the same events demonstrated the powerlessness of the consuming countries, and stimulated a growth of National Oil Companies (NOCs) in these countries so as to demonstrate something was being done about the energy question to their electorates, and in some measure lessen their dependence on the Multinational Oil Companies. Thus the perception of the event of 1973, in consuming and producing countries alike, stimulated a growth in the number and importance of National Oil Companies (NOCs). (Para 4.12)

Experience of the attitude of Sir William Fraser, the Chairman of A.I.O.C. (later BP) in the Iranian Crisis, caused Labour Ministers, whether for or against intervention, to conclude, that the British Government could not in a crisis rely on BP to be an effective instrument of Government policy, in those cases where there was a conflict of interest between the policy objective and the commercial interests of the company. The 1973 Oil Crisis demonstrated to the Heath Government, and to the Labour Party, the powerlessness of the Government in the face of a coalition of MNOs, so that both Parties judged that the existing legal provisions for the control of North Sea oil, had to be supplemented by appropriate organisational means. (Para 4.21)

Labour were committed to the extension of State control over British industry, so that the creation of B.N.O.C. was a natural development from this commitment, while the Conservatives were trapped within their commitment to oppose the extension of State control, and were aware of the manner in which State industries, once established, acquire the ability to delay and resist denationalization. In practice, B.N.O.C. was set up, because given the condition of the Oil Company Government relationship, full nationalization was impractical, while the proposed Conservative regulation was too weak. (Para 4.22)

Oil Company representation on the B.N.O.C. Board was excluded, so as to protect the perfect information possessed by the Corporation through its membership of all Operating Committees, even those where it held no equity. Exclusion of Oil Company representation, ensured that the decision making process was uncontaminated by an oil industry viewpoint. Treasury and Department of Energy representation on the Board, which went beyond the roles normally assigned to the Civil Service, was designed to facilitate the close working together of the Corporation and the Government in extending control over North Sea operations. (Para 4.3)

The Labour Government strove to change the North Sea operating environment to favour B.N.O.C., and regime changes, together with operational decision making were held up till a time favourable to the interests of the Corporation. Combined with bureaucratic delays, which arose from both the formal regulatory authority, the Department of Energy and B.N.O.C., considering all matters in tandem, so that their roles

became in effect merged, this situation brought a strong reaction from the oil industry, against what they saw as unfair advantages given to the Corporation. (Para 4.3.)

While both the Corporation and the Government were engaged in extending B.N.O.C.'s powers in the North Sea, no conflict of interest arose between them. In negotiating the Britoil Loan, the Corporation was able to pay off some of its higher interest borrowing from the National Oil Account, and by linking the security of the Loan against forward sales of its crude oil, it engaged in a defensive strategy, which constrained the speed with which a future Conservative Government might engage in privatisation. (4.3)

On reaching Office, the Conservatives, given their ideological commitment, and conscious of the strong reaction of the oil industry to B.N.O.C.'s special privileges, moved swiftly to reduce these privileges even though this necessitated slowing the implementation of the 7th Licensing Round, for which these changes were a necessary prerequisite. However, initial plans for privatisation, partially a product of the Government's need for finance, were shelved in response to an argument by Lord Kearton that the disposal of wealth creating assets would deprive the Government of a future stream of profits, while the more immediate consequence might be to endanger the Britoil Loan, based as it was on the ongoing sales of North Sea crude oil in the U.S.A. The Government's financial needs might better be met by an increase in the forward selling of this crude oil, an operation in which B.N.O.C. already had considerable experience. (Para 4.4.)

In February 1981, enabling legislation to carry out privatisation was introduced, and though it was not completed in that Session, in October 1981, the new Secretary of State for Energy, Nigel Lawson, a determined monetarist, announced plans to press ahead with privatisation, which appeared likely to be persisted with, since the immediate requirements for Government finance, without placing an extra burden on the Treasury, now outweighed any longer term disadvantages, such as those pointed out at an earlier date by Lord Kearton. In the event, privatisation measures, involving hiving off B.N.O.C.'s exploration and production activities into a new company, and their sale to the public, were carried through in 1982. (Para 4.4.)

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Chapter 5 Conservative North Sea Policy, 1979-1981, and the Impact of Economic Policy, as demonstrated through Two Case Studies, the Gas Gathering Line Case Study, and the Clyde Field Development Delay Case Study.

5.1 Introduction In Chapter 4, the creation of the British National Oil Corporation (B.N.O.C.) by the Labour Government in 1975, and the changed role assigned the Corporation by their Conservative successors, provided an illustration of the progressive divergence of Labour and Conservative North Sea policy, along lines determined by the ideological attitudes of the two Parties, on the proper means for organising industry. The present Chapter will show that the nature of the Conservative Government's North Sea policy was also substantially formed by the requirements of its economic policy, an economic policy which was highly congruent with Conservative ideological attitudes on the proper means for organising industry. This economic policy consisted in a re-ordering of those economic priorities which had been the norm for both Labour and Conservative Governments alike, from 1945, so as to place the control of inflation to the fore amongst economic objectives, in a monetarist strategy aimed to cure what the Conservatives perceived to be Britain's underlying economic problems.

The new Conservative economic policy introduced in May 1979, was the result of a reassessment of recent British economic experience made by the Party while in opposition, and the nature of this reassessment, together with the assumptions behind the new policy will be set out in Para 5.11. The interplay of economic assumptions and ideological attitudes which contributed to the foundation of Conservative economic policy, was influential in

bringing about the Conservative Government's decision to revert to its earlier policy of partial North Sea privatisation after 2½ years in Office, a decision which was considered in Chapter 4. Now, with the basis of Conservative economic assumptions set out, it is appropriate to briefly reconsider this decision in Para 5.12, so as to highlight the various factors involved, since the same economic assumptions (and the underlying ideological attitudes), can then be shown to have been important considerations in Case Studies of two decisions, the Gas Gathering Line Case Study, covered in Para 5.2, and the Clyde Field Development Delay Case Study, covered in Para 5.3. Thus a picture will be built up showing the extent to which Conservative North Sea decisions in the period 1979-1981, were strongly influenced by the Government's economic assumptions and ideological attitudes.

5.11 Conservative Economic Policy From 1945 onwards, British Governments had four economic objectives: economic growth, full employment, stable prices and a surplus on the balance of payments. (1) Through the 1950's and 1960's, the main indicators by which economic welfare was judged, were economic growth and full employment, the former of which was considered to represent the full use of economic resources over the long term, and the latter of which was held to represent the full use of the same resources in the short term. The predominant economic policy objective was the maintenance of full employment. The objective of stable prices was accorded a somewhat lower priority, since a low but relatively stable level of inflation was regarded as a stimulus for economic growth. Under the system of fixed exchange rates established in 1944 at Bretton Woods, periods of 'go' or economic growth created pressure on the balance of payments (through the increased imports needed to meet the demands of expanding production and the buildup of

consumer demand), which condition led to periods of 'stop' or economic constraint, designed to damp down demand and reduce pressure on the balance of payments. In 1970, the end of the Bretton Woods System introduced an era of more flexible exchange rates, while from the middle 1970's, the build up of North Sea crude oil production from the northern part of the U.K. Sector, progressively reduced the adverse impact on the balance of payments which resulted from crude oil imports. Yet despite these favourable developments, there was a substantial increase in inflation from the late 1960's onwards, to well above the 4-5% annual rate, formerly considered acceptable. These higher inflation rates, occurred together with economic stagnation, a condition which was termed stagflation.

In looking at this experience, the Conservatives believed they could identify an underlying factor linking the whole picture together. They believed that current inflation was creating unemployment, and preventing economic growth. Because of this, the problems of the economy could no longer be handled by the by now traditional Keynesian means of deficit financing and Government priming of the economic pump, designed to correct failures of demand. Instead, the Conservatives concluded, the problems of the U.K. economy resulted from a series of failures of supply, and to meet these supply side failures, economic policy should be aimed at achieving two objectives. Incentives had somehow to be restored in the economy, and this objective could in some measure be achieved through a restructuring of the tax system. But the principal burden of economic strategy must rest on measures to achieve the second objective, the reduction of inflation. Only as inflation was squeezed out of the economy could soundly based economic growth take off with any real prospect for sustained employment. This

Conservative economic policy would promote stable prices to the prime economic objective, while economic growth and full employment were demoted in the short term, on the grounds that they would follow from the conquering of inflation.

Given this view of the British economy, when the Conservatives took Office in May 1979, the Government embarked on an economic policy, built around three sets of assumptions:

- (1) Prices can only rise continuously if the money supply rises, and the direction of causation is from increased money supply to increased prices.
- (2) There exists a natural rate of employment and output, and the economy will adjust to this natural level fairly quickly, in response to a condition of stable prices.
- (3) An increase in the Public Sector Borrowing Requirements (PSBR), and hence the national debt, will in the end lead to an increase in money supply. There is a fixed quantity of resources available for investment in the economy at any one time, and the more of these resources used up in the public sector, the less will be available in the wealth generating private sector.

It will be shown how these economic assumptions and their associated ideological attitudes influenced Conservative North Sea decisions between 1979 and 1981. In like fashion a Keynesian view of the economy informed the views of the Government's critics in the debate over these decisions. In this context it is helpful to set out briefly the Keynesian view of the Government's economic assumptions. In summary these are as follows:-

- 1) While accepting that unless money supply rises there can be no rise in prices, Keynesians believe that the view that the direction of causation is always from money supply to inflation, is hard to sustain given the practical experience that inflation creates a demand for money.
- 2) While accepting that overtime employment and output will probably adjust favourably to a condition of stable prices, Keynesians point out that the link in this process is not clear, and consider the contention that the adjustment will occur fairly quickly to be highly debatable.
- 3) While most Keynesians consider a degree of control over the money supply is highly desirable, they believe the extent to which emphasis is placed on this policy instrument to be excessive. Neither, they feel, can the degree of control aimed at by the Conservatives, be achieved in practice.

Although enough has now been said to highlight the serious doubts which

exist amongst economists about the validity of the Conservative Government's economic programme, the two Case Studies will nevertheless revert to the issue, wherever it is central to the contemporary debate on the decision under consideration. Of far greater importance in the context of these decisions is the manner in which the Government's economic assumptions and Conservative ideological attitudes on the proper means for organising industry appeared to interact to bring about the chosen course of action. Indeed, now that the economic assumptions behind Conservative economic policy have been identified, it becomes clear that these economic assumptions and the Party's ideological attitudes on the proper means for organising industry cannot simply be regarded as two distinct though highly congruent interacting variables, rather they have to be regarded as two somewhat overlapping circles in Venn diagram. Of course, all economic assumptions possess an ideological content, though in this case it is rather salient. At the same time, the ideological attitudes of the Conservative Party on the proper means for organising industry, point in a complementary fashion to its economic programme.

As an example of the interaction between economic assumptions and ideological attitudes on the proper means for organising industry, consider the link between the condition of stable prices and the renewal of economic growth. Keynesian economists consider this link uncertain, though they grant that renewed growth is likely to occur in the long run. The view that output will adjust fairly quickly to a condition of stable prices is sustained for Conservatives by a belief in the superiority of private enterprise to public enterprise. A particular virtue of private enterprise relates to the latent entrepreneurial drives held to exist within British Society. With incentives

restored in the economy, and with business freed from the debilitating effects of inflation, then surely these latent entrepreneurial drives must bring about the desired growth.

It is this close mesh of economic assumptions and ideological attitudes on the proper means for organising industry which lay behind the Conservative decision to revert to their initial policy of partial North Sea privatisation after 2½ years in Office. With the background provided by this added analysis of Conservative motivation, this decision will now be briefly reconsidered to highlight the factors involved, as a prelude to the two Case Studies.

5.12 The Return to North Sea Privatisation The decision to hire off the Upstream (exploration and production) activities of B.N.O.C. into a new company called Britoil, 51% of whose shares were to be sold off to the public, while leaving the Corporation with its profitable oil trading operations, had clearly been taken by the end of 1981, even though the full range of measures necessary to implement this decision were not completed till the following year. In Chapter 4, this decision was attributed to the Government's need for money to meet its current liabilities, and its fears of fresh commitments arising from the revelation of weaknesses in Public Sector financial forecasts. However, these immediate and obvious reasons for the decision did not seem to provide a sufficient reason for setting aside the stream of profits argument earlier advanced by Lord Kearton. Before considering this decision afresh some additional background is needed.

In 1979, when the Conservatives took Office, receipts from Petroleum Revenue Tax (PRT), the principal tax on North Sea oil production, represented only 1% of the Government's total tax income, ⁽²⁾ but thereafter, receipts from PRT rose so sharply that in 1983 it was conservatively estimated the receipts from PRT would provide £8,000 million or 13.5% of all tax income. PRT arises from all North Sea oil production, irrespective of whether this is from Public Sector or Private Sector acreage. It is a characteristic of all the energy industries that they require massive ongoing levels of investment to provide for future supplies. Investment in the North Sea to date totals £30,000 million, and a further £60,000 million will need to be invested to maintain U.K. oil self sufficiency into the 21st Century. For our purposes, no detailed description is required of how PRT is constructed, but it should be observed that it is very difficult to design such a tax, the aim of which is to skim off economic rent in a single sector of the economy. This problem, together with the need for ever increasing revenue has caused the Government to modify the tax frequently since its inception in 1975. Up to March 1981, these changes consisted of increasing the rate from 45% to 75%, halving the tax free oil allowance, and reducing the uplift allowance for capital expenditure, while the March 1981 Budget applied constraints to the uplift and safeguard provisions. That PRT is not a progressive tax, but falls with uncertainty on oil fields of varying size and technical difficulty has been impressively demonstrated by Kemp and his associates at the University of Strathclyde in a series of papers. ⁽³⁾ The Conservative Government's need for additional revenue led to the introduction of a new tax in the March 1981 Budget called Special Petroleum Duty (SPD). As a result, by the end of 1981 there were 5 ways in being for taxing oil and gas, all of which were based on separate measures:

Royalty; Corporation Tax; PRT; SPD; and a new gas levy. The whole system of oil and gas taxation as briefly described above was arguably a deterrent to exploration, and at best very complex. In October 1981, in response to a Government call for suggestions on the issue of oil and gas taxation, both organisations offshore operators, U.K.O.O.A., representing the larger Operators, and Brindex representing the smaller Operators but forward their proposals for improvements in the tax regime. The changes announced by the Government in 1983, provided real encouragement for North Sea investment, (4) so that the area is now regarded (5) as amongst the most attractive in the World for Upstream investment. Of course, any country with a high proportion of revenue derived from oil will suffer from a sharp fall in oil prices. (6) Weakened prices not only reduce the revenue from crude oil sales, they reduce the propensity to invest, both in the Private and Public Sectors.

As the Government's income from PRT rose, or as it anticipated such a rise, so the relative importance of the still large B.N.O.C. income from crude oil sales tended to assume a lesser importance in Government thinking. Crude oil prices have generally been weak in the late 1970's and early 1980's as a response to World depression, with the exception of the large though temporary increases induced by the fall of the Shah in 1979 and the onset of the Iran Iraq War in September 1980. All crude oil sales are quoted in \$U.S. Thus the two variables through which crude oil prices impact directly on the U.K. economy are the price of North Sea crude oil in \$U.S., and the \$U.S. Sterling Exchange rate. B.N.O.C. is the price setter for North Sea crude oil.

With this background, the partial privatisation decision can be looked at in the light of the Government's economic assumptions and ideological attitudes.

According to the Government's economic assumptions, there exists at any one time only a fixed quantity of resources available for investment. The greater the investment in the Public Sector, the less will be available in the Private Sector. This is known as the 'crowding out' effect. Conservatives believe strongly in the superior virtues of the Private Sector's investment, considering it to be the primary source of real wealth generation. Any increase in Public Sector investment (even if self generated by the industry concerned) carries with it the risk that through some miscalculation a fresh financial burden may be placed upon the Government, possibly leading to an increase in PSBR, and a consequent rise in inflation.

In terms of these assumptions and with a need to invest £60,000 million in the North Sea, it would make sense to lessen Public Sector involvement in the North Sea and at the same time to improve the attractiveness of the area for Private Sector investment. Thus when Nigel Lawson, a determined believer in the Government's economic strategy (who was later to become Chancellor) took over the Department of Energy from David Howell, these various factors were all accorded added weight. When combined with the problems of continuing the funding of welfare payments at a time of rising unemployment and providing for the heavy needs of the Defence Budget, these considerations led to a firm resolve within the Government to return to the earlier policy of partial North Sea privatisation of B.N.O.C.'s Upstream (exploration and production) activities, as part of a general programme for the disposal of

saleable Public Sector assets in various parts of the economy. These considerations will also be illustrated in the following two Case Studies.

5.2 The Gas Gathering Line Case Study Chapter 3 described how in the late 1960's interest in the North Sea switched from the southern gasfields to newer oilfields in the north between latitudes 56°N and 62°N. Yet in this northern region, there also existed large untapped resources of natural gas, and this Case Study is concerned with the decisions of the British Government as they effected some of the measures proposed to bring these resources ashore and utilise them.

Natural Gas in the northern North Sea is potentially recoverable from three sources: gasfields, similar to those in the southern North Sea, though not generally of a size to merit full development on their own account; associated gas, or gas produced in association with crude oil production, which if not brought ashore must be flared, or reinjected in the reservoir, either to maintain pressure, or to meet environmental requirements; and gas condensate fields. A gas condensate field, in very simple terms, is a hydrocarbon reservoir in which under conditions of initial temperature and pressure the fluid exists as gas in its entirety. As this fluid in the form of gas is extracted, so a drop in pressure occurs, and a liquid condensate is formed by a process known as retrograde condensation. Condensate is also produced by other means. If a stream of gas is processed, then it is possible to extract from it Natural Gas Liquids (NGL's) which form a highly profitable chemical feedstock, even given the generally depressed conditions of the chemical industry in the early 1980's. The NGL's consist principally of any or all of the following: ethane, propane, butane, pentane, hexane and heptane. In some cases, higher hydrocarbons such as methane may also be

present. Gas may also be classified as dry gas, the normal stock in trade of British Gas, or wet gas which consists of condensate or NGL's.

Specification gas is the term applied to dry gas after it has been processed to meet the requirements necessary for its delivery to British Gas.

A 1980 estimate of the quantity of gas recoverable from the northern North Sea via a gas gathering line of 572 miles of 36" pipe (the system on which the decisions in this Case Study were taken) gave figures for recoverable gas as follows:

- (a) U.K. 1980's gas, known as firm UK gas, 5.3 TCF (Trillion Cubic
though actually subject like all these Ft)
figures to considerable uncertainty.
- (b) Future U.K. gas, principally from gas 6.9 TCF (Trillion Cubic
condensate. Ft)
- (c) Norwegian gas from the Statfjord 7.7 TCF (Trillion Cubic
Heimdahl and Sleipner fields, then Ft)
viewed as potentially exploitable
via a U.K. system.

The cost of bringing this gas ashore via the proposed system of 572 miles of pipe was estimated in April 1980, as likely to be around £2.9 million. By September 1981, this proposed system had evolved by a foreshortening of its northern and southern arms, into a 420 mile system, the estimated cost of which however, had by then risen to £2.7 billion. It was on this foreshortened Line, that the Conservative Government took its September 1981 decision not to provide the necessary financial guarantees which would have permitted the scheme to go ahead. This change from a 572

mile system to a 420 mile system and rose from a downgraded assessment of reserves, together with a decision by Norway to exploit her own reserves, once it was shown to be technically feasible to lay a pipeline across the Norwegian Trough. Thus the Norwegian economy would gain the full value added of their own gas. The foreshortened scheme would recover some 11 TCF compared with some 20 TCF under the full scheme.⁽⁹⁾

The interests wishing to exploit these natural gas resources were several. The U.K. Government had a number of reasons for wishing to see this gas exploited. Aside from its contribution to the U.K.'s future energy requirements, the building of such a system would have useful macroeconomic effects on employment and investment. While the U.K. demand for gas had increased to 16,876 million therms in 1981-1982, production from the British Sector of the North Sea had dropped from its highest level of 14,974 million therms in 1977 to 13,176 million therms in 1981, following a sharp decline in the production of the southern gasfields developed in the late 1960's, from which the country obtained 77% of its requirements. The shortfall was made up through imports of Norwegian gas. To counter the effects of declining production from the southern gasfields, British Gas saw the proposal to bring fresh gas ashore from the northern North Sea, as a means for providing an important part of its requirements for the 1980's and 1990's. The chemical industry (of which the Multinational Oil Companies (MNOCs) form such a significant part) considered the resulting Natural Gas Liquids (NGLs) as a most valuable feedstock, while the construction and process plant industries viewed the development as a contribution to fighting their way out of recession. Behind the consensus, the perceptions of these actors were sometimes different and on occasion in conflict.

To complete the background for this Case Study, consideration has to be given to the 3 feasibility studies made for a gas gathering line, each prepared at a separate point in time but each of which took account of 2 other systems, then at an advanced stage of construction, the FLAGS system and the Frigg pipelines. The FLAGS (Far North Natural Gas Liquids and Associated Gas System), primarily designed to take gas from the 4 platforms of Shell/Esso's Brent Field to a plant at St. Fergus on the coast of Aberdeenshire, was designed so that the separated NGLs were afterwards to be piped to a petrochemical plant at Mossmoran, The Frigg Pipelines were two in number, one British and one Norwegian and both were to take gas from the Frigg Field, which straddles the U.K./Norway boundary line, to yet another processing plant at St. Fergus. By taking certain technical risks the capacity of the Frigg pipelines might be extended, while as gas production began to decline from the Brent Field, from the middle to late 1980's, extra capacity would become available in the FLAGS network.

In 1975, the then Labour Government recognised the value of gas and condensate from the northern North Sea, and while they appreciated that a single line from each deposit to the shore would be uneconomic, they realised that a gas gathering line linking some 20 of these sources together might prove viable, as each field accessed would take a share of the cost. Accordingly, the Department of Energy commissioned the following report from a firm of Newcastle consulting engineers: Williams-Merz. A study of gas gathering lines in the North Sea. A report to the Department of Energy, May 1976. Part 1 of this report covered commercial fields in the northern part of the U.K. Sector, while Part 2 was restricted to the larger commercial

fields. To ensure the effective transport ashore of the gas and condensate resources involved, the report recommended the use of 4 pipeline system, the Frigg pipelines, the FLAGS system, and two further new pipeline systems. However, in commissioning this report, the Department of Energy called on the consultants to produce their work quickly, being afflicted by the 100 days mentality then prevalent within the Labour Government. In order to produce their report by 13.5.76, the consultants were forced to make a number of simplifying assumptions, most significantly, they excluded the impact of Norwegian gas from their considerations. On publication, it was recognised that though valuable, the report was flawed by the emphasis placed on speed of production by the Labour Government.

Realising the limitations of the Williams-Merz Study, Anthony Wedgewood Benn at the Department of Energy, concluded that further study of the problem of bringing northern North Sea gas ashore was essential. The conclusions the Williams-Merz Study had reached about the desirability of four pipeline systems, would not secure the desired finance in view of the doubtful assumptions on which it was based. In order to carry out a fresh feasibility study, a new company was formed, called Gas Gathering Pipelines (North Sea) Ltd, which included both Public Sector and Private Sector interests likely to benefit from the construction of any new system. On the Private Sector side the interests represented were ICI, RTZ and Total, while the Public Sector was represented by B.N.O.C. and British Gas. The two Public Sector organizations involved formed a new company called British Marine Pipelines Ltd., to represent their joint interests in the investigatory group.

The results of this new set of investigations were finally published as: U.K. Department of Energy. Gas gathering line systems in the North Sea. A report by Gas Gathering Pipelines (North Sea) Ltd., London, H.M.S.O., May 1978. (Energy paper 30). This report was highly sensitive to the issue of exploiting deposits of uncertain dimensions and on this basis concluded that no new major pipeline systems were needed to supplement the Frigg and FLAGS systems, although the authors recognised their conclusions were finely balanced, and might need to be altered, should any of the underlying factors be subject to change. For example, a significant rise in energy prices might alter the balance in favour of building an additional major gas gathering system.

By the Spring of 1979, it was the perception in the Department of Energy, that the underlying situation had indeed changed and David Howell, the new Conservative Energy Secretary announced to the Commons on 5th July 1979 that he had asked British Gas and Mobil North Sea Ltd., to carry out a design and feasibility study for a new northern North Sea gas gathering pipeline system. Their report delivered to the Minister in April 1980, was then published as: U.K. Department of Energy. A North Sea gas gathering system, London, H.M.S.O., May 1980 (Energy Paper 44). The report concluded that in addition the Frigg Pipelines and the FLAGS system, a further gas gathering system was justified, and proposed the Scheme (first mentioned at the outset of this Case Study) for a 572 mile, 36" pipeline linking together a dispersed range of deposits. A line from the Magnus Field (the northern leg) was to run south and form a subsea junction with a line running north from the Fulmar Field (the southern leg). From the subsea junction, another line was to carry the gas westward to a landfall at St. Fergus, were a gas

separation plant would be built, at which NGLs (Natural Gas Liquids) were to be separated, which in turn were to provide the feedstocks, for a new petrochemical plant to be built at Nigg Bay.

In June 1981, the Petroleum Economist observed⁽⁸⁾ that while oil reserves estimates had been reduced in the latest issue of the Department of Energy's 'Oil and gas resources of the United Kingdom' an annual publication published in the same month, the estimates of gas reserves included, were somewhat increased, and part of this increase was attributable to new condensate discoveries in the northern North Sea. The writer added that the Department of Energy's gas reserve estimates, like those for oil, might well prove on the conservative side, and considered that the main impetus for the development of these resources would be the proposed gas gathering pipeline, as a result of which it would be possible to exploit smaller gas fields and some of the associated gas produced by oilfields. Why was this scheme for a gas gathering line not proceeded with, how was the Government involved, and what was the aftermath?

On June 19th, 1980, David Howell announced⁽⁹⁾ that in his view a pipeline along the lines advocated in Energy Paper 44, would be in the national interest, and stated that he had invited British Gas, BP and Mobil to form an Organising Group, which together with a financial advisor would investigate how a pipeline organisation could best be structured as a Private Utility Company, outside the Public Sector. He further told the Commons that he envisaged British Gas taking a 30% share in the equity of this new company, a step which in his judgement would have no more than a minimal effect on public expenditure. As for the remainder of the equity, this would

be distributed between companies holding offshore production licences, customers who wished to purchase the resulting NGLs (Natural Gas Liquids), and the financial institutions. Thus from the outset, it was clear that the Government wished to place clear limits on the extent of public involvement. If Norwegian gas was to be brought ashore through the system, then Norwegian interests would have a share in the equity. The Organising Group would work with a target of setting up a pipeline company along the proposed lines by the Autumn of 1980.

The members of the Organising Group set up a Joint Venture to carry forward the pre construction work. British Gas was to be responsible for onshore work, while BP handled any offshore construction and Mobil looked after the necessary technical services. The main features of the Government's guidelines for this Organising Group were as follows:

- (a) The permanent organisation would be a Private Utility Company, providing a transmission and processing service, on a cost of service basis.
- (b) It should afford access to all customers on a fair basis of equality of access, so long as capacity was available.
- (c) Equity should be held as follows: British Gas 30%, Gas producers 20%; a further 20% shared among companies in the petrochemical industry; Financial institutions 30%.

With these firmer guidelines, the Organising Group was then expanded by the addition of a representative of a Merchant bank and an official from the

Department of Energy. By December 1980, apart from the question of the route to be followed, the problems faced had resolved themselves into two categories: (10)

- (1) The financial problem of who would fund the Gas Gathering System.
- (2) The question of who would obtain the valuable NGLs.

The rival claimants for the NGLs were the 'establishment' companies (BP Chemicals, ICI and Shell/Esso) who wanted them piped south to feed the Mossmorran complex, and the BP plant at Grangemouth (together with the BP/ICI joint ethylene plant at Wilton, on Teesside) and the 'newcomers' (principally Dow Chemical Corp), who promised a £400 million ethylene cracker at Nigg Bay, Cromarty. In this latter group were Occidental Petroleum, who offered to set up a £200 million development at Peterhead, and Highland Hydrocarbons, who offered to build an £845 million plant for ethylene production, also at Nigg. Hoechst, the West German Chemical Group, similarly offered to make a large investment in a plant at Nigg.

In effect there were 7 sellers of gas, and 43 possible purchasers of NGLs, which underlines the commercial value of the feedstock at stake. All the schemes proposed had different implications for the economy, and it was very difficult to evaluate the benefits to be derived from them. Dow claimed that their scheme would provide 15,000 additional jobs for the Scottish economy, while Highland Hydrocarbons claimed 350 permanent jobs, 2,000 jobs in the construction industry, and a massive multiplier effect. The 'establishment' companies did not offer to create new jobs, but they nevertheless had a strong argument, for they claimed that all the new

proposals for Nigg Bay were impractical in view of the depressed state of the market for ethylene, and that in so far as they did go ahead this could only lead to a loss of jobs elsewhere. Following the 'establishment' approach however, would defend jobs in existing plants. The 'newcomers' pointed out that BP suffered from a dual role, being both a member of the Organising Group, and a claimant for the NGLs.

To cut through the difficulties associated with evaluating the various proposals, David Howell told the Commons on 17th December 1980, that he had decided to allow commercial negotiations to decide the issue of who obtained the feedstocks. B.N.O.C. was to be made the substantial seller (wholesaler) of these feedstocks. Although this was a victory for allowing the market to decide the issue, it was nevertheless a defeat for the non interventionists within the Cabinet, since it provided a role for B.N.O.C. It could be argued that allowing the market to decide the issue might not achieve the best possible outcome from the standpoint of the economy, but it was very difficult to establish just what this might be given the conflicting claims of the chemical industry.

However, the issue of who would obtain the resultant NGLs was irrelevant, unless finance could be found to build and operate the system. In a further statement on behalf of the Government, made on 17th December 1980, Hamish Gray, then the Minister of State, said that a company to run the new pipeline would be set up by March 1981, "umpteenth banking groups and other financial institutions" were interested in financing the line.⁽¹¹⁾ Originally, it had been intended to set up the necessary company to run the new line by December 1980, but by March 1981, the date for setting up the

company named by Hamish Gray, the Organising Group, who had by then spent £8 million on preliminary work, had already informed the Secretary of State, that in view of the high risks involved, financing and operating a company within his guidelines was not possible.

The difficulties which made a company established within the Secretary of State's guidelines impractical were two fold. Firstly, British Gas were only willing to pay a relatively low price for the dry gas landed, compared with prices on the international market, so that the operating companies considered the scheme non viable in commercial terms without an improved offer from the only permitted purchaser of British Sector gas(BGC). Secondly, it was now becoming clear that the Norwegian now believed they had a technical solution available for the problem of laying a gas pipeline across the Norwegian Trough. Thus the availability of Norwegian gas to the system was in considerable doubt, as the Norwegians might well prefer to land their gas in their own country, and capture all the resultant economic benefits.

Given the above difficulties, the Organising Group, now believed that if the scheme was to get underway, an interim company would need to be set up, supplied with bridging finance, and start construction of the system, by placing contracts with BP and British Gas, the managers of the Project. By March 1981⁽¹²⁾ a group of 6 banks, led by the Bank of Scotland, were estimating a £700 million funding to enable work to be started on the £2,000 million Project. This money would bridge the time till sale and purchase contracts for the gas had been signed and the financial prospects were rather clearer. The group of 6 banks required a guarantee that all the gas set out

in the Feasibility Study would flow into the system, and no new pipelines would be built to access the gas in question.

By May 1981, however, the Norwegian Government had backed a plan of the Statfjord Group (Mobil and Statoil) for two new gas gathering lines in the North Sea. Wet gas was to be landed at Karsto, north of Stavanger, and dry gas after the separation of NGLs gas to be piped back into the Sleipner field. Both the Sleipner and Heimdahl fields would then be linked to the Ekofisk complex, and their gas piped south to Emden in West Germany. Thus the input to the proposed system of Norwegian gas was definitely removed. In the meantime, it had been decided that further evaluation of the reserves of the Fulmar field was required, since this field might well justify its own pipeline to shore. As a result of this consideration, it was decided to terminate the southern leg of the proposed system further north at the Lomond field. Similarly, it was decided that the northern leg (to the Magnus, Murchison and Thistle fields) would now best be handled by a separate line into the FLAGS system. Thus for a restricted system accessing less gas the financial institutions were being asked to find more funding. As indicated earlier, the estimated costs of a 420 mile system were now in excess of estimates established earlier for a 572 mile system.

Cost estimates given at various times were: £1.1 billion (June 1980); £2 billion (late 1980 March 1981); £2,340 million plus £404 million for onshore facilities (May 1981 for restricted scheme). From these figures, it appears

that elements of a Concorde style escalation of costs existed within the Project. This was a condition to which a Government committed heavily to the control of PSBR might be highly sensitive, especially when it was combined with doubts concerning commercial viability, expressed by the oil industry, even when these related to the industry's constant complaint over the low price to be paid for the gas brought ashore. The Organising Group, however, continued to express its full confidence in the viability of the Scheme. By contrast, the banks became increasingly wary of the scheme's viability. As these uncertainties grew, so the price to be paid for the gas by British Gas became a crucial factor. Without an adequate guarantee on price, the oil industry was not ready to invest in the necessary facilities. The Banks were ready to provide the necessary £2.7 billion but only if that loan was guaranteed as a result of firm contracts being agreed between gas producers and British Gas. Since the oil companies were holding out for a better price than British Gas were ready to offer, only one such contract was ever signed. The Banks, lacking the security necessary for such a large loan, then approached the Government for financial guarantees.

The Treasury objected strongly to this proposal that the Government should provide financial guarantees for a loan from the Banks, on two grounds. Firstly, there was the fear of an impact on PSBR, and secondly, the dangers inherent with an open ended commitment, by which the Government might be trapped in a British Leyland type commitment, from which they could only extricate themselves at a very large cost. Certainly, a gas gathering line was no 'lame duck', but it did involve risks, and Ministers were highly sensitive to those risks, given the experience of BL and Concorde. The Banks, then suggested that British Gas might be able to raise sufficient money on the financial market to get the scheme started, after which other

investors might be prepared to tag on to the scheme, once it was shown to be viable. However, the Treasury took the view, that since ultimately the Government stood behind British Gas, these proposals were no more than a disguised form of the direct guarantees plan. At this point, interest swung back to the original possibility of the oil companies providing the necessary finance. This, once again, they were not prepared to do, unless they first obtained satisfaction, on the price they were to receive for the gas they were to bring ashore. British Gas was paying them between 6p and 16p a therm for gas at that time, and selling it at 28p to the domestic consumer. The oil companies were only ready to finance the project for 26p a therm plus tax concessions.

If the oil companies were each to separately build a North Sea pipeline, then they would be permitted to offset the costs against their separate liabilities to pay PRT. However, a pipeline company would have to be formed to build a gas gathering system, to which several companies would have to make contributions, and such contributions could not be set against the participants' separate PRT liabilities. The Majors wanted the right, which would be presented as no less than equitable, to offset their individual expenditures on a collective enterprise against their individual tax liabilities. Though an equitable proposal, those tax liabilities were scheduled to provide the Conservative Government with an increasing element of its total tax revenue in the years ahead, and for this reason the companies' proposition was unlikely to be acceptable. Indeed, so anxious was the Government to increase its revenues from the North Sea still further, that in March 1981 the Budget had introduced a new Special Petroleum Duty (SPD) to meet this requirement. The companies however, were motivated by

their long experience of the low price paid for British Sector gas, and an awareness of the leverage they might exercise over the Government as a result of the estimated £25 billion revenue which the proposed gas gathering system might be expected to yield over its lifetime. Moreover, as the companies pointed out, if they built a series of separately funded alternative networks instead of the proposed integrated scheme, they would anyhow deprive the Government of considerable revenue as a result of tax offsets. In practice, PRT provision of facilities with shared use (e.g. pipelines) were finally relaxed, effective 1/7/82.

The companies took the view, based on long experience of dealing with both the British and Norwegian Governments, that these Governments regarded the North Sea as a tap, which would be turned on readily whenever revenue was required, or an investment had to be made, without detriment to long term energy provision. While this approach might be somewhat credible for a country such as Norway with a long term energy surplus, the companies wished to forcibly demonstrate that this was not the case with the U.K. The Government appears to have had some sympathy with the companies' long standing complaint over the level of gas prices, but was not prepared to concede the principle of tax changes at that time. Furthermore, in order to meet the companies' wish to offset their separate expenditures on a collective enterprise against their individual tax liabilities in the gas gathering line situation, the provision would have had to be somewhat generalised. Once the principle of offsetting expenditures on collective enterprises against PRT had been accepted, many more projects would tend to acquire a collective status. In this connection, it is necessary to recall the manner in which the oil industry quite properly took advantage of the

more liberal tax regime prior to 1975.⁽¹³⁾

The critical Cabinet Meetings prior to the refusal of guarantees by the Government took place on the 10th and 11th September, 1981. On 10th September, 1981, Dr. Jeremy Bray (Labour), MP for Motherwell wrote to The Times ⁽¹⁴⁾ on the issue in a somewhat mocking fashion. He suggested that difficulties over funding the Gas Gathering Line arose from two quarters. Firstly, there was a lack of clarity on the part of the Government, concerning the respective roles of public and private capital. Private capital would prefer a scheme which merely milked off the obvious profit, while public capital ought to aim for a maximisation of total profit and total supplies. This argument, was the traditional case for the long term benefits to the community which derived from public enterprise. However, the second point went beyond what The Times on 2nd September, 1981 had described as the Treasury's 'obsession with the concept of Public Sector Borrowing Requirement'. It was the view of The Times that Private Sector borrowing would not be contrary to the Government's strategy, but Public Sector would be, in view of its impact on PSBR. However, Dr. Bray pointed out, evidence to the Commons Treasury and Civil Service, ⁽¹⁵⁾ Mr. Ryrie, the Second Permanent Secretary of the Treasury had stated "an increase in investment, whether public or private, must be accompanied by a reduction in other expenditure.... the effects of different ways of financing the investment are of secondary importance." Since this statement implied a radical departure from what he had always regarded as the Government's strategy, Dr. Bray asked Ryrie on 15th June 1981 (p.60 of the Report)" so Private Sector borrowing has an identical impact to Public Sector borrowing?" In reply, Ryrie answered, "I think they are very similar in their effects, yes." On 13th July,

Mr. Brittan, Chief Secretary to the Treasury, had confirmed that this was indeed the case. In Dr. Bray's view, as a result of these statements, it was clear that the Government were uncertain as to whether they were operating on money supply or money national income.

John Flemming, Chief Economic Adviser to the Bank of England, had stated on 13th July, 1981 (p.226 of the Report) that "it could be argued that the nominal income target was itself a form of incomes policy." Thus Dr. Bray concluded, if one does not wish to influence either incomes or prices in a direct sort of way, then any investment, be it public or private, must be compensated for with cuts elsewhere, be they in the Public or Private Sectors. It was this dead end, and the dilemma it presented, which in Dr. Bray's view, was really demonstrated by the Government's difficulties over the funding of the gas gathering line system. According to A.P. Thirwall, (16) the Government's economic policy was an amalgam of monetarist ideas, and the old classical theory of employment, which still persisted within the Treasury. This old classical theory of employment, holds that there is a fixed quantum of resources, and the use of part of this fixed quantum through Government investment, excludes its use by the private entrepreneur. Professor J. Williamson, in a Memorandum to the Treasury and Civil Service Committee in July 1980 (17) was critical of the monetarist dimension of the Government's economic policy, stating the to treat (as in his judgement the Government was doing) inflation unadjusted PSBR, nominal value, cyclically unadjusted (as a target)) as a constraint upon economic policy, let alone as a objective of that policy, was economic barbarism.

The Government, however, were probably more concerned over immediate and

practical difficulties, rather than the theoretical difficulties raised by Dr. Bray and others. If they refused financial guarantees, and the companies felt justified in going ahead with their own projects, then revenue would be lost through PRT offsets, but the responsibility and the risks of the whole enterprise would belong to the oil industry, relieving the Government of a potential long term commitment. If the oil industry did decide, notwithstanding the gas price issue, to proceed with various additional gas gathering measures on their own account, the overall result might prove sub optional for the economy as a whole, compared with the proposal on which they were being asked to provide financial guarantees, nevertheless those measure would still provide considerable macroeconomic benefits. By turning down the request for financial guarantees (or 'leaving it on the table') all risk would be avoided, and a public demonstration given of the Government's adherence to the control PSBR. By comparison with this demonstration, sophisticated criticisms of Government policy in the columns of The Times, and elsewhere, would soon be forgotten.

However, in addition to these considerations, it was generally believed by most of the Cabinet, that the provision of financial guarantees for the gas gathering system, which carried the risk of a potential long term involvement with the project, might draw the Government into activities, which Conservative ideology and strategy would place well outside its proper functions. In this connection, it should be recalled, that by September 1981, the Government were committed to divesting B.N.O.C. of part of its Upstream (exploration and production) activities in favour of the Private Sector. Provision of financial guarantees for a gas gathering system would thus have been at variance with the general thrust of Government policy.

In the month prior to that series of Cabinet Meetings, when the decision was taken to leave the question of providing financial guarantees for a gas gathering system 'on the table' a number of Ministerial Meetings took place, at which was decided to ask John Liverman (a former Civil Servant at the Department of Energy, who had also been a director of B.N.O.C.) to collate the views of all possible participants in the scheme. It was as a result of the Liverman report, that the majority view within the Cabinet, which was opposed to the provision of financial guarantees, became reinforced. It appeared that the financial institutions and the oil industry were not prepared to risk their own money in the scheme, and the fear was, that this reflected general doubts on the commercial viability of the scheme, rather than a specific dispute over of the price to be paid for the gas. (18)

Thus in summary, the factors militating against the provision of financial guarantees, in the minds of the majority of the Cabinet Ministers, were as follows:

1. A determination to hold the line PSBR, and not to lose credibility with committed Conservative supporters in the country.
2. A deeper conviction that the provision of financial guarantees for a gas gathering line was wrong in terms of Conservative ideology and economic strategy.
3. Doubts over the viability of the scheme arising from the withdrawn of Norwegian gas, and the unwillingness of the oil companies and financial institutions to risk their own capital.

4. Fear of an open ended commitment.

The minority support within the Cabinet for providing the necessary financial guarantees, was based on the following considerations:

1. To make certain of the full macroeconomic benefits, even though these were somewhat indeterminate at the time of the decision.
2. To ensure, as rapidly as possible, the saving of energy currently being lost in the shape of flared gas.
3. They believed the financial return on capital invested would be good. Sir Martin Ryle (19) had indicated this could be 4 x PWR reactors.
4. In energy terms (again according to Sir Martin Ryle) the gas gathering line would be 12 times more effective than investment in nuclear energy.

When the decision was taken not to provide financial guarantees for the gas gathering system, the minority view in the Cabinet favouring their provision, was led by David Howell, the Secretary of State for Energy. His Minister of State was Hamish Gray, who in the immediate aftermath of the decision, indicated that he expected British Gas to raise its prices to the oil companies to provide them with a stimulus to go ahead with their own schemes, although he ruled out the prospect of any PRT concessions to achieve this end. In the Cabinet reshuffle which followed shortly on the decision

not to provide financial guarantees, David Howell was replaced by Nigel Lawson, who on 19th October reaffirmed the Government's intention to carry forward a partial privatisation of B.N.O.C.'s Upstream (exploration and production) activities, at the same time retaining British Gas's position as the only seller of gas to domestic consumers. Thus the price paid by the Corporation to the oil companies providing its gas, would remain an important determinant of the viability of any scheme to bring it ashore.

The twin events of September and October, 1981, namely the refusal of financial guarantees for the gas gathering system, and the clear statement of intent to carry forward a partial privatisation of B.N.O.C.'s Upstream (exploration and production) activities, formed a watershed in the handling of North Sea policy. This watershed marked a definite eclipse of the influence within the Cabinet of that part of the Conservative Party which still favoured a greater degree of intervention in North Sea strategy, and the dominance of those elements, both within the Party at large, and the Cabinet in particular, seeking to limit and if possible reduce the extent of the State's involvement.

In the following year, the Petroleum Economist reported in June, that the Brent Field was to begin supplying associated gas through the FLAGS system, and would soon be meeting 12% of U.K. gas demand. The western extension of FLAGS would allow gas from the Ninian, North Cormorant and South Cormorant, and later N.W. Hutton, fields to feed into the system, while the northern leg, due to come into operation in the following year, would take gas from the Magnus and Thistle Fields, and the U.K. part of the Murchison Field. In April 1982, the companies participating in the Magnus, Murchison

and Thistle Fields, signed contracts with British Gas, which were reputed to involve the Corporation in agreeing to pay the companies around 19p a therm, a significant improvement on their past experience.

5.3 The Clyde Field Development Delay Case Study On 23rd July, 1980, David Howell, the Secretary of State of Energy, announced to the Commons (20) that he intended to delay the development of certain North Sea fields discovered after 1975 so as 'to prolong high levels of U.K. Continental Shelf production to the end of the Century'. The first two such fields to be considered were the Clyde Field, and the Phillips T Block. At the same time, the Secretary of State made it clear that no decisions had been made on any pre 1975 fields after 1982, the period to the end of which was covered in the Varley Guidelines. On 18th December, 1980, David Howell announced (21) that the delay to be applied to the Clyde Field's development would be of two years duration, and that as a consequence it might be expected to come on stream (i.e. into production) in 1988. The background to the decision to delay the development of the Clyde field, and the choice of two years as the period of that delay, are the subject of this Case Study.

The estimated cost of development of the Clyde Field at the time the decision was taken, was £500 million. Ownership of the field was split between B.N.O.C., the field's Operator, and Shell/Esso. The impact of B.N.O.C.'s expenditure would fall on the PSBR. It was conventional wisdom up to the time of the delay decision, that the U.K. should not become a net exporter of crude oil in the 1980's, but should hold production down, so as to extend the use of the resource over the longest possible period. In the early 1980's, Britain achieved a condition of crude oil self sufficiency,

which it was expected would fluctuate around a small net input or export figure throughout the decade. Such was the formal basis for depletion control through delayed field development. It was believed the middle 1980's would see a sharp peaking then a sharp fall off in North Sea crude oil production.

However, it is necessary to consider how this condition of crude oil self sufficiency has actually been reached. It has been achieved through a combination of production which has consistently fallen below target, with a fall off in demand as a result of recession, and a high sensitivity to increased prices by the users of oil products. Crude oil prices in the 1980's have generally been depressed, compared with the generally higher levels of the 1970's, the exception being the sharp rise briefly experienced at the onset of the Iran-Iraq War (1980), which together with an earlier temporary sharp rise (1979), occasioned by the Fall of the Shah, constituted the Second Oil Shock. As a result of these factors, it was later appreciated that the sharp peaking and falling off of North Sea crude oil production anticipated for the middle 1980's was unlikely to occur, but instead would be replaced by a flattened production curve, extending the use of the resource over a longer period, without the need for formal depletion controls.

From the standpoint of an oil company, once a significant oil discovery has been made, it is generally in the best interest of the company to move as rapidly as possible through development to the production phase, so as to recoup investment. Even so, it may take several years to complete the development phase, and begin to obtain a return on the investment involved.

The means available to the U.K. Government to secure depletion control are several, and are not restricted to development delays. They are as follows:

- a) Production Cutbacks Powers exist to introduce formal cutbacks in production, i.e. production cuts in producing fields, under the Petroleum and Submarine Pipelines Act, 1975, and the Energy Act, 1976. A restraint on the application of these cutbacks are the Varley Guidelines, which consist of assurances (without the force of legislation), given by Eric Varley, that production from pre 1975 discoveries would be safeguarded from such cuts till 1982 or four years from the beginning of production, whichever was the later. Thus from 1982, the Government was free from all constraints in determining the rate of lifting from all fields producing in 1981, with the exception of the following four fields, where the constraint would end on the date given in parenthesis: South Cormorant (1983); Murchison (1984); U.K. Statfjord (1983); Tartan (1985).

Since production estimates and reserve estimates contain many uncertainties, formal production controls represent a flexible policy instrument from the Government standpoint. They can be employed, or relaxed, according to requirements arising from changing reserve data, and variations in national energy needs, but open ended cutbacks of this type, unlike the Varley Guidelines, will tend to appear in a random fashion, from the standpoint of oil company planning, and their use if persisted with, would tend to discourage exploration.

- b) Development Delays From the standpoint of the investor, the development delay (the method considered in this Case) is the best option. The basic oil company calculations on viability are not interfered with by a development delay. Unfortunately, development delay implies a stop go policy, with serious consequences for construction industry planning, and adverse effects upon the infrastructure of North Sea supporting services. Moreover, such development delays must have a bad impact on the general momentum of North Sea exploration and development, which has to be maintained in order to bring the smaller North Sea fields into production. It is these fields which will be required in the late 1980's and 1990's so as to maintain production when currently producing fields are in decline. Because of the very long lead time between a decision to develop an oilfield, and production startup, which may be 5 years, and since production startup has to be followed by an extensive production buildup phase, delays in 1980 could not be expected to have much impact on the hump in production then expected to occur in the middle 1980's. In short, the development delay applied in this Case was a very blunt instrument, which might not even hit the target.
- c) Royalty Banking If the Government chose to defer taking any crude oil due to it as a royalty, then revenue would be lost, but a production cutback would be achieved without too serious an impact on oil company planning. (22) A variant upon this approach would require B.N.O.C. to leave its own equity crude in the ground, but to do this would be most unfair to the Corporation, given that it is now required to act like any other oil company.

- d) Exploration Delays In view of the need to constantly increase the knowledge of oil reserves so as to plan for the future, this would be a highly irresponsible approach to depletion control.

While not a formal method of depletion control, delays on the development of marginal fields can be achieved by the impact of unfavourable oil taxation conditions thus inhibiting development effort. It is for this reason that North Sea Governments cannot regard the North Sea as a fiscal tap to be turned on or off at will, since their fiscal measures may have an effect on the rate of exploration and development, and hence on long term energy requirements.

In June 1981, the Petroleum Economist ⁽²³⁾ reported (6 months after David Howell announced the Clyde field development delay) that of the 16 U.K. oilfields then in production, 7 were either flowing at their peak or already in decline, while three further fields were expected to peak in 1981, and a further 5 were expected to reach their production peak in 1982. Of fields in the development stage, they were 8 in number, with the following estimated production startup dates: North Cormorant, Fulmar, N.W. Hutton (1982); Brae, Magnus and Maureen (1983); Beryl B and Hutton (1984). A further 9 significant prospects were then at the appraisal stage which precedes development. BP announced to the Houston Exploration Conference in 1981, that it was aware of 75 fields in the North Sea, capable of being developed in the following 20 years. Thus, there was a generally favourable company view of the North Sea future, clouded only by problem of raising the large investment finance necessary from reduced profit margins, a factor which

influenced their need for an improvement of the North Sea tax regime in their favour.

On the basis of this data considered against the background of 2 scenarios for the 1980's in the North Sea, a two year development delay for the purposes of conservation did not make sense. If, as the earlier conventional wisdom foresaw, there was to be a North Sea production hump in the middle 1980's, followed by a sharp decline, then it would make more sense for conservation purposes to push the use of the resource still further into the future with a 5 year development delay. Assuming 5 years for development and a substantial period for production buildup, this would push utilisation of the resource into the 1990's. However, if the Government assumed the alternative scenario of a flattened production curve through the 1980's, then this would itself take care of conservation, making a development delay pointless, and bringing with it a downturn in the offshore supplies and construction business. A 5 year delay would have suited the Treasury, lessening further the impact on PSBR.

In July 1980, when David Howell made his statement of intent to apply a development delay to the Clyde field, there was a feeling this delay might prove open ended. In other words no formal delay would be announced, so no definite period would need to be attached to it. Then, in the latter part of 1980 certain technical problems occurred in the development of the Tartan field (linked with the Clyde field in David Howell's July 1980 statement), and although these difficulties were soon resolved, it appeared at the time that those difficulties would permit the development of the Clyde field to proceed without delay. B.N.O.C., as the Operator, and its partner Shell/Esso,

naturally wished to proceed without delay to recoup their costs to date, so that the 2 year delay applied by the Department of Energy appears to have been a compromise between this Corporation/Company view, and that of the Treasury, concerned over the possible adverse effect on PSBR, with the added virtue from the Government standpoint, that any such adverse effects would be delayed till after the likely date of a future General Election (1983).

However, given the plans to partially privatise B.N.O.C.'s Upstream (exploration and production) activities, reaffirmed by Nigel Lawson in October 1981, a further explanation of the 2 year development delay on the Clyde field is reasonable. This would be a sufficient period to enable B.N.O.C.'s Upstream activities to be partially privatised thus reducing the probable impact of the £500 million investment on the PSBR. In practice, this proved to be the case, for in August, 1982, Britoil the company formed to takeover B.N.O.C.'s Upstream activities, 51% of which were sold to the public, made an application for development of the Clyde field, so that by the end of the year the field was listed in the Brown book ⁽²⁴⁾ 1983, as under development (i.e well before the end of the formal development delay), which was very necessary in 1982, since the same publication shows a decline in development effort, which was having an adverse effect on the offshore construction and supplies industries.

However, the choice of a formal delay period of 2 years, had to be made on the basis of the maximum time it was likely to take to secure partial privatisation of B.N.O.C.'s Upstream activities.

The financial reports for the Major oil companies, (25) Shell, Exxon, Gulf, Mobil, Socal, Texaco, BP, for the year 1980, showed a 10% increase in net income compared with 1979, though BP net income had fallen 6%, and that of Shell had fallen even more sharply by 20%. The rate of return on capital invested for all the Majors had fallen from 24% (1979) to 21.9% (1980). It is of course very difficult to compare net income and rate of return on capital invested as between these companies because of the impact of exchange rate fluctuations, and variations in accounting methods. With this proviso, the rate of return on capital invested for Shell fell from 32.8 (1979) to 20% (1980), while that for BP fell from 38.5 (1979) to 27.1% (1980). All the other Majors suffered smaller falls in the rate of return on capital invested between 1979 and 1980, and the overall pattern was very significant in an industry where 82% of net income is subsequently turned into capital investment. Where increases in net income were recorded in 1980, much of the effect was reduced by a 40% increase globally in the taxes paid to Governments.

From the standpoint of the British Government in late 1980, the financial condition of the oil industry meant they could not be sure there would be an anxious queue of purchasers waiting to benefit from their proposed sale of B.N.O.C.'s equity. The institutional investors and the oil companies would seek to get the price down to an acceptable level, while the oil companies would press for compensating tax advantages, having regard to the review of North Sea taxation in train at the end of 1981, which Para 5.12 demonstrated produced a most attractive tax regime from the oil company standpoint by the end of 1983. It was probable that the sale of B.N.O.C.'s equity could not be completed till 1982, or maybe even later, and this assessment fitted well with a 2 year development delay on the Clyde field. Development could proceed once

the Government had divested itself of a substantial part of B.N.O.C., thus lessening the impact of any harmful effects on PSBR.

The Clyde field development delay of two years would appear therefore to have been dovetailed into a range of policy considerations: the achievement of a compromise between B.N.O.C. and the Treasury; the probable timing of the general election; but most important, the likely date for the achievement of partial privatisation of B.N.O.C. when the impact of the necessary investment on PSBR would be lessened. It was convenient however, to present the decision to the public as a measure designed to achieve conservation.

5.4 Summary of Conclusions

PRT as a proportion of total tax revenue, rose from 1% (1979) to reach an estimated 13% (1983). The prospect and actuality of this increasing stream of revenue reduced the relative importance of the 'stream of profits' argument with which Lord Kearton had deterred the Conservatives from partial privatisation when they first took Office, by pointing out how this would reduce B.N.O.C.'s income from crude oil sales. The Conservatives economic assumptions, which placed the control of inflation to the fore amongst economic objectives, became the predominant influence causing the Government to revert to its earlier policy of partial privatisation, by hiving off B.N.O.C.'s Upstream (exploration and production) interests into a new company called Britoil, and selling off 51% of the equity, while retaining the B.N.O.C. sales arm. These economic assumptions included the view that there was a fixed quantity of resources available for investment at any one time, so that the use of these resources in the Public Sector crowded out their use in the Private Sector, which Conservatives believed to be superior to the Public Sector as a source of wealth generation. Further, the Conservatives believed

that Public Sector investment was likely to increase PSBR, which would lead to an increase in money supply in turn resulting in inflation. The Conservatives knew that £60,000 million of investment was needed in the North Sea to maintain Britain's oil self sufficiency the 21st Century. These factors combined to convince the Government of the need to place limits on the role of the Public Sector in the North Sea, while encouraging the Private Sector through a liberalisation of the tax regime in the oil industry's favour.

(Para 5.12)

An investigation by an Organising Group of the prospects for funding a gas gathering line through a private utility company with limited public involvement, found that financing along these lines, as favoured by the Government, was not practical. The oil companies would not fund the project without concessions both on gas price, and the provisions of PRT, which they wanted altered so as to allow them to offset their separate expenditures on a collective enterprise against their individual tax liabilities, which last the Government would not concede for fear of a loss of revenue arising from more projects acquiring collective status. The Banks would not finance the scheme without financial guarantees either from the Government or British Gas, behind which of course, the Government ultimately stood. The Government had doubts over the viability of the scheme, arising both from the withdrawal of Norwegian input and the unwillingness of the oil companies and financial institutions themselves to take the risks involved. Government financial guarantees might lead to an ongoing Concorde like commitment with a serious impact on PSBR. Further, Government financial guarantees for a gas gathering system would increase State involvement in the North Sea, just when the general thrust of Government policy was to reduce that involvement. The twin events of September and October 1981, involving the rejection of Government financial guarantees for a gas gathering system, and the reversion to the

earlier policy of partial privatisation of B.N.O.C. were a watershed, marking the decline of the influence of the interventionists with the Cabinet and the Conservative Party, and the dominance of those elements seating to reduce and limit the State's involvement in the North Sea. (Para 5.2)

In terms of 2 possible scenarios of future North Sea production a 2 year development delay for the Clyde field did not make sense as a conservation measure. It represented a compromise between the requirements of Shell/Esso and B.N.O.C. who wished to avoid any delay, and the Treasury who favoured a 5 year delay to lessen still further any impact on PSBR in the near future. It put off such adverse effects till after the likely date of a future General Election, but more important it represented the period of time needed to ensure the completion of measures for the partial privatisation of B.N.O.C., which would in turn lessen State involvement in the North Sea and reduce the potential impact of the development investment on PSBR (Para 5.3)

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Final Conclusions The character of the 1934 onshore regime, and the circumstances surrounding its creation fit the model derived from Hossain. The National Government, for economic and (primarily) defence considerations resolved the twin problems of ownership and access which had till then prevented an oil search. Their aim was to stimulate such a search in an unproved oil province. Oil and gas was taken into Crown ownership, and Government licencees granted access to sites, subject to safeguards for landowners. Licence terms were generous to the companies, and probably designed with their covert assistance. Territory was assigned for many years with no provision for the renegotiation of terms during the period of the licence. The Administrative Allocation Licensing System gave the Government discretion in the allocation of licences, but saved the companies the costs associated with auction bidding. The balance of advantage in the Oil Company Government relationship definitely lay with the companies.

The offshore regime of 1964, was based on foundations laid in 1964. The aim was to explore for and then exploit southern North Sea gas, a project involving high risk and massive investment, and to employ a policy of rapid development, which both the Conservative and Labour Parties considered would provide a needed stimulus for the flagging U.K. economy. The limited offshore expertise then available, was substantially under the control of the Majors, which meant that the majority of it was in U.S. hands. In these circumstances, and in line with the Hossain model, the regime was shaped, principally by generous fiscal measures, to attract company commitment. The company hand in the Oil Company Government relationship was strong. A comparison with the Norwegian policy of slow development demonstrates how the strength of the company hand was reinforced by the rapid development policy.

Since the development period for the southern gas fields was relatively short, and both the companies and the Government wanted rapid development, this encouraged the use of established U.S. oilfield equipment suppliers, and led to only limited and unsuccessful efforts to stimulate an indigeneous offshore supplies industry. As a countervailing feature, the Gas Council was the only, or monopsony purchaser of gas except for non fuel purposes, which as Stern⁽¹⁾ points out, also had the effect of making it the substantial seller of gas. Under these conditions, gas was purchased from the companies at well below international market prices, for which they were compensated through extraction rates somewhat in excess of those required by the gas industry.

In 1964, as in 1934, and in line with the Hossain model, certain ownership of the resources to be exploited, was a prerequisite for securing investment. The decline of the Free Seas regime, and the process of enclosure initiated by the Truman Proclamation(1945), which was well advanced by the middle Sixties, operated against the setting up of a Regional regime. Britain, Norway and Denmark, together possessed the major share of North Sea coastline, but were not members of the E.E.C. Thus, those members of the Six with limited North Sea coastline, or who were either landlocked or energy disadvantaged (Belgium, France, Italy, Luxemburg) could not exercise leverage on them in favour of a Regional regime, by offering tradeoffs in other Community policy areas. An international regime for the North Sea, based upon its division into National Sectors, was created. Two UNCLOS principles(1958) were available to negotiators, were countries judged their adoption mutually useful. Though the resources to be exploited were believed to be considerable, there was no knowledge of their actual location, which

speeded the negotiating process. Britain accepted Norway's view of the geology of the Norwegian Trough thus avoiding a dispute which would discourage investment. This led to the straight application of the Median Line principle, which gave Britain 50% of the North Sea, since she was the only State on the western side of the North Sea, and the Equidistance principle did not apply. Cross boundary arrangements, including unitization of fields straddling the boundary between Norway and Britain, were resolved by a system of balanced and mutually exclusive responsibilities.

From 1969 onwards, interest shifted from the southern gas fields, to newer oilfields in the north of the British Sector. Given the rapid development policy, the longer lead time to bring such fields into production, and the truly massive investment required, and again in line with Hossain, the existing regime with its generous fiscal measures was retained intact. As awareness of the scale of the enterprise in the north of the British Sector grew, so to did demands for a revision of the regime, to produce an income for Britain similar to that obtained by other oil producing states.

Lord Balogh was a prime mover in the call for change, as a result of which, the Public Accounts Committee, 1972/1973, called for radical fiscal alterations, just before the oil crisis of 1973, with a view to altering the tax system which they described as being 'porous as a sieve'. However, again in line with Hossain, regime changes only occurred in 1975, when changes in the world oil industry and the state of development of the northern oilfields had sufficiently matured, to permit these changes to take place without hazarding the rapid development policy.

When the Labour Government introduced regime change in 1975, the measures applied were generally acceptable to the Conservative Party, who while in Government had prepared their own, not dissimilar plans. The fiscal system was completely changed through the introduction of PRT (Petroleum Revenue Tax). However, while both Parties, now considered there was a need for greater control over North Sea oil, in view of the heightened perception of the importance of the security of supply issued following 1973, and their experiences of dealing with BP and Shell, at that time, and on earlier occasions, the Conservatives opposed the setting up of B.N.O.C. as an agent for this purpose. With significant resources now under development or in production, and with the position of the Majors weakened elsewhere, thus increasing their commitment to the politically stable North Sea, policy need no longer be constrained within former limits. In 1975, therefore, the first breach in the bipartisan policy for the North Sea occurred, and thereafter the North Sea policy of both parties progressively diverged on ideological lines. The model derived from Hossain has no relevance to this development.

Under Labour, B.N.O.C. and the Department of Energy, worked in concert to strengthen the hand of the new Corporation. B.N.O.C.'s membership of all Operating Committees, gave it access to information and a total picture of North Sea activities, which was not available to private sector companies. Work was held up till B.N.O.C. was ready to take advantage of opportunities. The B.N.O.C. Board was constructed to exclude the company point of view and influence. To secure a B.N.O.C. interest in existing leases, by 'free' negotiation, the Administrative Allocation Licensing System was used to discriminate against those companies which failed to reach agreement on the issue.

When the Conservative Party came to power in May 1979, B.N.O.C. was removed from membership of Operating Committee where it held no equity, which removed a particular irritant that the oil companies felt to be unfair. The Conservatives in Opposition, had developed an economic policy, which placed the control of inflation to the fore amongst economic objectives. For them, private sector enterprise was superior to public sector enterprise, being the source of those entrepreneurial drives which they considered wealth creating. Control of Government expenditure, and reduction of PSBR (Public Sector Borrowing Requirement) were measures to squeeze inflation out of the economy, and thus set free those entrepreneurial drives they considered to be latent in society. Initial plans for privatisation of part of the State's offshore interests, in line with this philosophy, were delayed by Lord Kearton's stream of profits argument, as well as by the persistence within the Conservative Party of important interests who did not agree with the new economic policy. With the growth of revenue from PRT, Kearton's arguments held less strength. The two Case Studies, relating to the refusal of Government guarantees for the gas gathering line proposal, and the Clyde field development delay, show how both these decisions arose from the Government's economic strategy, and a fresh determination to privatise, which became clear towards the end of 1981, with the eclipse of those elements within the Conservative Party opposed to the policy based upon the concentration of all efforts on the elimination of inflation. In this sense 1981 was a watershed year.

In 1981, measures were already in train to liberalise the tax system in favour of the oil companies, although the most recent changes did not materialise till the first half of 1983. However, while such measures

doubtless proceed from the Conservative philosophy which favours private enterprise, it is reasonable to conclude that they may also derive to a large extent from a realisation of the vast additional effort, requiring a further £60,000 million of expenditure, if the smaller North Sea fields are to be developed, without which British oil self sufficiency cannot be extended to the next century. In this sense, it is possible to finally conclude that the Hossain model is still relative to the situation, and is now entering into a second round of application, in response to this fresh challenge.

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